GERMANY AND THE POLITICS OF EUROPE'S MONEY

Karl Kaltenthaler

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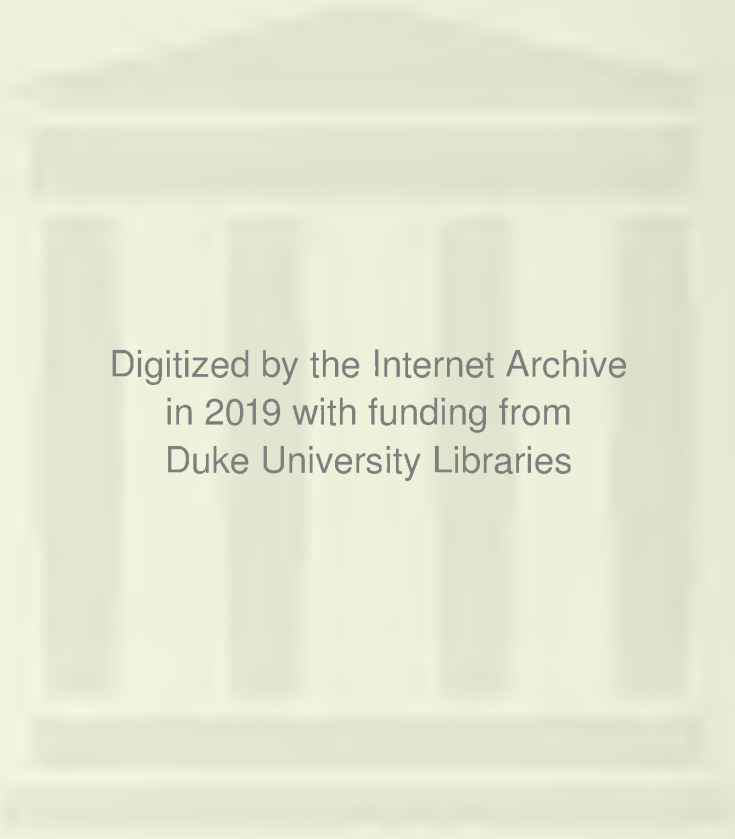
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Contents

Acknowledgments vii

1 Introduction 1

2 The German Monetary Paradigm: Actors, Interests, and Institutions 19

3 German Domestic Politics and the Development of the European Monetary System 42

4 Challenging Bundesbank Dominance: The Franco-German Economic and Finance Council Initiative 56

5 The Ties That Bind: German Policy Toward European Monetary Union 69

6 The Price of Change: German Policy and the Transformation of the EMS 90

7 Conclusion 109

Notes 117

Bibliography 131

Index 141

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Germany and the Politics of Europe's Money

1 Introduction

The Aachen cathedral that houses Charlemagne's throne could not have been a more symbolic venue for the meeting. On 16 December 1978, German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing met in Aachen, the capital of Charlemagne, emperor of both the Germans and the French, to discuss the institutional details of the proposed European Monetary System (EMS). But even as Giscard and Schmidt strode through the ancient cathedral in a show of solidarity, the cracks in the Franco-German condominium that was to create the EMS were beginning to show.

The reason for the tension in Aachen was Schmidt's reversal of his position on how the EMS should be designed. In February 1978, Schmidt had initially proposed the EMS to be a monetary regime in which each member would have equal obligations and privileges. Giscard had agreed to this proposal and the two had sponsored the monetary regime with this understanding of its future form. But at Aachen, a site chosen for its symbolism of Franco-German cooperation, Schmidt announced that he would only accept an EMS design where the country with the strongest currency, of course Germany, would serve in the anchor role and would not have the external monetary policy burdens that the weaker currency countries would have. Schmidt had made a major policy flip-flop.

This example of policy change seems to defy the conventional wisdom on German policy toward European monetary integration. In the literature on the subject Germany is portrayed as a state that consistently demands monetary ventures in Europe that conform to its vision of Bundesbank-like monetary discipline. Yet if one closely examines the record of German policy toward European monetary institutions, it quickly becomes obvious that German policy exhibits a great deal of *discontinuity.*

On several key issues of European monetary integration, not just policy toward the creation of the EMS, the German government has changed its position, without any obvious explanation. In 1987, the German government

proposed a Franco-German Economic and Finance Council to coordinate monetary and economic policy with the French government. Within a year the German government had stripped the council of any policy-making power. When the initiative to create the European Monetary Union (EMU) was launched in 1988, the German government reacted coolly. But within a year that same government had become one of the initiative's most enthusiastic supporters. Only one year after the signing of the Maastricht Treaty, in the summer of 1993, German monetary policy brought about the near-collapse of the European Monetary System (EMS) and the possible derailment of the EMU process. The German government, which had hailed the Maastricht Treaty as "a triumph for Europe," referred to the quasi-collapse of the EMS as "liberation" for German monetary policy, although it could have spelled the end of the EMU plan.

Why do we see this puzzling discontinuity in German government policies regarding European monetary institutions? This study seeks to answer this question. It traces the dynamics of German policy toward European monetary integration to offer a more complete picture of that policy than presently exists. The second goal of the book, and this will be the more important contribution to our understanding of politics, is to develop a framework to explain the factors that account for the dynamics of policies toward international institutions. This framework is used to explain the dynamics of German policy toward European monetary institutions.

I argue that in order to understand the dynamics of state policy toward international institutions it is necessary to comprehend how international institutions affect domestic politics. International institutions are important to domestic politics because they may constrain both international and domestic policy choices for state actors if they choose to abide by those institutions. By constraining policy choices they determine who gets what in the domestic political arena. Current scholarship on European integration points to the domestic distributional ramifications of the process. As Eichengreen and Frieden (1993, 1, 19) point out in reference to European Monetary Union:

> EMU is also a political phenomenon in that the decision to create a single currency and central bank is not made by a beneficent social planner weighing the costs and benefits to the participating nations. . . . Interest groups support or oppose the initiative depending on how it is likely to affect their welfare, not the welfare of the nation or the Community as a whole. . . . We need a clear picture of the domestic interests at stake and the institutional setting within which they are situated.

Because international institutions can affect distributional outcomes within polities, groups in society and the state will have a vested interest in shap-

ing policy toward the design of international institutions. The policy response that these state and societal organizations can undertake will be shaped by the structure of domestic political institutions. Thus the key to the dynamics of German state positions regarding European monetary institutions lies in how groups within Germany expect European monetary institutions to affect their share of economic or political gains and how domestic political institutions constrain their policy options. Because German policy institutions give so many state and societal organizations a say in the making of policy toward European monetary institutions, that policy has been characterized by a great deal of discontinuity.

Why Germany?

There are several salient reasons to single out German policy toward European monetary institutions for study. First, it is abundantly clear that Germany is pivotal to the process of integration because of its economic power. The sheer size of the German economy means that the relationship of the Federal Republic to European Union (EU) monetary institutions is crucial to the destiny of those institutions. Also, the importance of the deutsche mark as an international currency lends the Federal Republic a central role in European, as well as international, monetary affairs. This importance of the deutsche mark has given the Bundesbank, the highly autonomous German central bank, and the German Finance Ministry an enormous amount of power in the course of European integration.

Germany's economic power has allowed it to have a key role in shaping monetary institutional change within the EU. Although Germany is only one of several European Union member states that played a role in the instances of institutional change examined in this book, no state played as large and important a part in shaping the final institutional outcomes. Germany's frequent policy changes toward European monetary institutions matter. They matter because German policy has largely shaped the course of European monetary integration. One need only look at the process of European monetary integration to see how the dynamics of German policy has left its imprint on the shape of Europe's monetary affairs.

Germany's influence on the final design of the European Monetary System is very evident. German Chancellor Helmut Schmidt, the initiator of the EMS, hoped that the new monetary regime would lend the European Community the exchange rate stability thought necessary for further European economic and political cooperation. He hoped the new monetary regime would increase trade and economic growth, and save the Common Agricultural Policy (CAP) from the ravages of exchange rate fluctuations. Finally, Schmidt hoped that the

EMS would be a regime where all member states would share the responsibilities of membership equally. This vision of the EMS attracted the support of other European leaders. But German policy toward the EMS was also crafted by the influence of the Bundesbank, which meant German domestic price stability had to be protected. The EMS that saw light in March 1979 was essentially a deutsche mark zone, with the Bundesbank playing the central role in the regime and thereby dominating the monetary as well as economic policies of the regime's members. Schmidt's initial proposal for the EMS gave way to a more Bundesbank-inspired view of what Europe's monetary institutions should look like. If the European Community wanted a stable exchange rate regime, it had to go along with Germany's demands.

A number of scholars have come to argue that the Bundesbank has been able to maintain a relatively autonomous monetary policy despite its obligations to the EMS (Bofinger 1988; Camen 1986; Mastropasqua et al. 1988; Obstfeld 1983; Rieke 1984). The Bundesbank has been able to maintain its own domestic monetary policy goals while other EMS members, such as France and Italy, have had to substantially tailor their domestic monetary and economic policies to mimic the policies of the Bundesbank in order to stay in the EMS.

What accounts for the Bundesbank's dominant position in EU monetary politics? The institutions, or rules, of the EMS place the Bundesbank in a dominant position because they have put the burden of exchange market intervention and domestic adjustment on those states whose currencies are weak and fall toward their lower band limits. The EMS's institutions do not place adjustment burdens on those currencies which appreciate from the agreed upon central exchange rates. Weak currency countries, that is, those countries whose currencies often come under depreciating pressures (France, Italy, the U.K., etc.) have had to use very large portions of their currency reserves to buy up their own currencies to keep them within the EMS's bands. They are also forced to set their domestic monetary and economic policies to coincide with those of the Bundesbank so as to avoid divergent tensions between their currencies and the deutsche mark. This significantly reduced their policy autonomy, tying their hands in time of recession.

Thus, simply stated, the rules of the EMS have profound implications for the domestic politics of the regime's member states. The distributional consequences of those rules have meant that the members of the EMS have interests to either maintain those rules, alter them, or replace them with a new set of institutions. This situation of Bundesbank dominance in the EMS has essentially meant that some members of the regime, particularly France and Italy, have had the following choices: follow the Bundesbank's monetary policies, and thereby possibly abandon many of their own domestic political-economic

priorities; withdraw from the regime and possibly endanger the future of European integration; or try to change the European Community's monetary institutions. Although France and Italy chose the first option in the early 1980s, by the late 1980s they felt that the rules of the EMS, as they existed, conflicted with their economic and political goals.

Between 1987 and 1993, several changes in the European Community's monetary institutions took place, due in large part to dissatisfaction with the German domination of European monetary politics. The first major challenge to Bundesbank dominance in European monetary politics was the Franco-German Economic and Finance Council initiative. The council was formally proposed by the French government in 1987 as an amendment to the Franco-German Friendship Treaty of 1963. Although not a multilateral EU arrangement, the council was meant to coordinate German and French monetary and economic policy in the context of prompting further convergence between the two states and thus deepening the integration process. The council proposal was greeted with enthusiasm from the German government, which saw it as an opportunity to strengthen Franco-German cooperation in monetary affairs. Despite the German government's support of the council, in the end that same government effectively stripped the council treaty of any mention of policy-making power. This effectively robbed the treaty of any real significance.

Frustrated by failed attempts to dismantle Bundesbank dominance by EMS reform, the French government proposed an even more radical venture in monetary institutional change in 1988, the European Monetary Union. The EMU proposal did not mean to reform the existing monetary institutions of the European Community, as did the previously mentioned episode; it aimed at replacing them with an entirely new set of monetary institutions, institutions which would have substantially reduced the sovereignty of the EU member states. At first, the proposal was rejected by the German government, but within a year the German government reversed its position and embraced the EMU project. During the negotiations on the institutional design of EMU, the German government maintained a hard-line stance that it then abandoned at the Maastricht Summit in December 1991.

Not two years after the signing of the Maastricht Treaty, which the German government claimed was a victory for Germany and Europe, the EMS was transformed from a fixed exchange rate regime to a more or less floating system. The transformation, occasioned by an exchange rate crisis brought about by high German interest rates, represented a serious threat to the continued validity of the EMU process. But instead of lamenting the transformation of the EMS, the German government seemed to welcome it.

The above summary of Germany's changes in policy toward European monetary institutions demonstrates how crucial those policy changes have been to the trajectory of European monetary integration. Germany, due to its economic and political power, has pulled, and sometimes dragged, Europe along its desired path of monetary institution building. A dynamic German policy toward European monetary integration has been a significant contributing factor to the unevenness of Europe's attempt to establish its own monetary institutions.

The Need for a New Approach

Germany's importance to European monetary politics is one very good reason to study the dynamics of German policy. But another very important reason to devote attention to this subject is the lack of a sufficient analytical framework for understanding the politics behind Germany's policy dynamics. The literature often neglects the dynamic aspect of policies toward European monetary integration. States are very often treated as unitary actors with unchanging positions toward monetary issues. This vision of stultified policy is largely inaccurate, particularly in the German case. It is particularly important to capture the politics behind the pattern of frequent changes in German policy, as it is so very crucial to the dynamics of the *entire* European monetary integration process.

Theories of international institutions would be the logical place to look in international relations theory for understanding why a state would frequently change its policies toward international institutions. A literature on international institutions centering on the concept of international regimes developed in the late 1970s (Cohen 1983; Nye and Keohane 1977; Keohane 1983, 1984; Krasner 1983a, 1983b; Ruggie 1975, 1983; Stein 1983; Young 1983, 1988). International regimes have been defined as "principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given issue area" (Krasner 1983b, 5).

Neofunctionalist theories of the emergence of international regimes are the most influential explanations of the creation of international institutions (Nye and Keohane 1977; Keohane 1983, 1984; Young 1983, 1988). These theories argue that states create international regimes because they reduce the transaction costs of interactions in the international system. Thus the system-level theories offer plausible answers to why there is a general demand for international institutions, but they cannot explain the dynamics of policy choices toward international institutions. That entails understanding the mechanisms of policy making, and that means moving to the domestic level of analysis. Keohane

argues that "policy conceived as if the world consisted of billiard ball states guided by philosopher-kings is not very useful. For international regimes to govern situations of complex interdependence successfully they must be congruent with the interests of *powerfully placed domestic groups within major states*, as well as with the structure of power among states" (Keohane and Nye 1977, 226).[1]

Haggard and Simmons (1987), in a very influential review article of the international institutions literature, also point out the limitations of system-level analysis for understanding the dynamics of state behavior toward international institutions/regimes: "Current theories of international regimes have ignored domestic political processes, in part because of the lure of parsimonious systemic theory. This neglect has extended to the issue of how regimes actually influence national policy choices. . . . There are both methodological and theoretical reasons to open the black-box of domestic politics" (Haggard and Simmons 1987, 513). Thus in order to understand why states behave the way they do toward international institutions, one must examine policy making *within* the states. What is needed is an understanding of how international institutions affect domestic politics and how, in turn, domestic politics will determine state policy toward those institutions.

Increasingly scholars of international relations have heeded the need to take account of how *domestic* politics affects states' choices toward international institutions (Haggard 1992; Haggard and Simmons 1987; Huelshoff 1992; Keohane and Nye 1977; Simmons 1993; Sobel 1994). These works have examined why domestic political actors want to create or change international institutions or how international institutions can affect domestic political outcomes. A similar vein of research focuses on how the international economy affects various aspects of domestic politics (Garrett and Lange 1996; Gourevitch 1975, 1986; Katzenstein 1988; Keohane and Milner 1996; Rogowski 1989). Students of foreign policy have also taken a close look at how domestic politics conditions state policies in the international realm (Katzenstein 1978; Lamare 1991). These studies are greatly expanding our understanding of the relationship between domestic and international politics and provide a foundation for this study. What is missing from these studies, however, and what this study seeks to provide is a systematic way of explaining how domestic politics shape policy dynamics toward international institutions.

Empirical studies of European monetary politics also do not provide the answers sought here. State-centric studies, which touch on Germany's policy toward the European monetary institutions, are the most common (Giavazzi and Giovannini 1991; Hanrieder 1990; Garrett 1993; Kaufmann 1986; Kennedy 1990; Pomfret 1991; Sandholtz 1993; Story 1988). State-centric approaches as-

sume that state actors are largely autonomous political actors with their own interests, policy preferences, and power resources (see, for example, Evans, Rueschemeyer, and Skocpol 1985; Krasner 1980; Nordlinger 1981; and Sacks 1980 for a defense of the state-centric approach). Thus, in examining Germany's policies toward EU monetary institutions, state-centric studies have ignored or assumed away the importance of German societal organizations and have focused overwhelmingly on the interests and behavior of the organizations of the German state.

Wayne Sandholtz's (1993) study of German policy toward EMU is a good example of this state-centric approach to policy toward international institutions. The following statement exhibits the importance Sandholtz attaches to how state elites shape policy: "Monetary union offered Germany few if any economic benefits. The staunch commitment of Foreign Minister Hans-Dietrich Genscher to European integration explains much of the support for EMU, especially given Bundesbank skepticism. . . . In short, foreign policy ideas seem to provide the best explanation for German support for EMU, especially the enthusiasm evinced by Genscher and Kohl" (Sandholtz 1993, 33, 38).

No state-centric studies of German policy toward European monetary institutions have focused on the pattern of changes in German policy toward European monetary institutions. A problem with using a state-centric approach for this study is that it cannot sufficiently tell us why certain German state actors are able to realize their policy or institutional design preferences in some instances yet not in others. For example, why was the Bundesbank able to block the aspects of the Franco-German Economic and Finance Council it disliked but could not block the path to EMU negotiations as it wanted? We can assume that the Bundesbank's political power did not change much, yet we see different political outcomes: why? It seems we must bring in players other than state actors to explain this.

Marxist studies have also been a common vein of research on Germany and its role in European Community monetary affairs (Hueglin 1992; Lankowski 1982 a and b; Manfrass 1984; Ménudier 1976, 1981). They assume that the state replicates the structure of its domestic socioeconomic system (Warren 1972; Boddy and Crotty 1975). The German state is viewed as the superstructure of the German capitalist class. According to the Marxist perspective, the German state/capitalist class views the economic domination of Europe to be in their interest; European monetary integration is seen as a means to that end.

Hueglin's (1992) study of German policy toward the European Monetary Union provides a good example of the logic of the Marxist model of policy making concerning international institutions. He argues the following about German motives for the plan for a European Central Bank: "Given the de-

gree of de facto influence which organized business and banking have over both industrial and monetary policy in West Germany, and considering the Deutsche Mark hegemony already existing in the Community, it is plausible to assume that West German politicians, bankers and businessmen simply do not expect that situation to change fundamentally in a European context with European institutions and policies. *Modell Deutschland* would simply become *Modell Europa*" (1992, 301).

As with state-centric studies, no Marxist study has centered on the pattern of discontinuity in German policy toward European monetary institutions. In fact, Marxist studies stress the *consistency* of German policy. They also are weakened by evidence from the empirical record which contradicts their logic. In the cases examined here German state actors initiated policies that sometimes contradicted the wishes of German capitalists. For example, German state actors (except the Bundesbank) agreed to the Franco-German Economic and Finance Council although the plan was *opposed* by German industry and banking organizations. Marxist analyses are at a loss to offer an answer to why this conflict occurs.

What is missing from all of the studies mentioned above is an analytical framework which is dedicated to explaining the dynamics of policy toward international institutions. This study develops a model of policy dynamics that is based on two premises. The first premise is that domestic political actors will be interested in the shape of international institutions because of the way those institutions determine domestic distributional outcomes relevant to their interests. This premise is based on North's (1990) and Knight's (1992) theories of institutions. The second premise is that the formal and informal institutions of policy making will shape the options these domestic political actors have in making policy toward international institutions, thereby affecting the dynamics of that policy. This study will show that it is the numerous institutions of German policy making, and specifically the large number of state actors involved in policy making and the manner in which interest organizations can influence policy, which accounts for the very dynamic nature of German policy toward European monetary institutions.

International Institutions and Domestic Politics

Institutions are generally defined as the humanly devised constraints that shape human interaction (North 1990, 3). They are the rules of society. They may be either formal or informal. Examples of formal institutions would be a constitution or codified property rights. Informal institutions include the "unwritten rules" of society or the conventions that constrain behavior. International in-

stitutions are the rules states establish for their interactions. The rules of the Bretton Woods monetary regime, the rules of the GATT trade regime, and the rules of the European Monetary System are examples of international institutions. Norms of international behavior which have developed between states also constitute international institutions. These may be norms of cooperation in such areas as economic and monetary management. But international institutions can never be formal institutions in the same manner domestic institutions can be, as the international system lacks a central enforcer equivalent to the state at the domestic level (Keohane 1981; Knight 1992).

Although the concepts of institutions and organizations are often used interchangeably in social science literature, it is prudent to distinguish between the two concepts. Organizations are purposive entities designed by their creators to achieve objectives within the institutional structure of society (North 1990, 4–5). Examples of organizations would be political parties, interest groups, a central bank, or a government ministry. Thus institutions may be seen as the boundaries of the field within which the players (organizations) compete.

Why do individuals or organizations choose to create institutions? North (1990) argues that organizations create institutions to reduce uncertainty and lend a stable structure to life. Uncertainty produces transaction costs in social exchange because actors are forced to expend resources to ascertain the costs of what is being exchanged. Institutions lend order and predictability to transactions by constraining the options available to organizations. Organizations want that predictability so that they can accurately plan for the future.

According to North, organizations engage in institutional change in response to changes in the context of interaction or changes in their preferences (North 1992, 83). Changes in the contextual environment of interaction, in North's view, affect actors' incentives toward keeping the institutional status quo, since institutions may impede actors' ability to respond as they wish to changes in the environment (North 1990, 84).[2] Those who believe that they will be better off from a change in the rules of interaction, in light of changes in the environment, will strive to change institutions to benefit themselves. Those may be organizations that stand to gain from such changes as well as organizations that stand to lose from relative price changes. Thus organizations that seek to maximize gain or minimize losses will be willing to pick up the costs of changing institutions (North 1990, 84–88).

Knight (1992) posits that actors may create institutions to make transactions easier for themselves, but they also may create institutions to give themselves a distributional advantage over others. According to Knight, institutions are important determinants in distributional outcomes. Because of this distributional importance, actors will battle over the shape institutions should take.

He argues that it is the way in which the costs and benefits of institutions are distributed to particular actors and the resources they use to either initiate or stifle institutional change that determines the shape of institutions. He claims that changes in the distributional consequences of institutions or changes in the relative bargaining power of the relevant actors account for actors' incentives to engage in institutional change (Knight 1992, 145).

How can North's (1990) and Knight's (1992) theories of institutions be applied to the question of how international institutions affect domestic politics? The key idea to take from these theories of institutions is that international institutions can structure political conflict and policy coalitions among domestic actors by the way they structure or may be expected to structure the distribution of substantive benefits from political and economic interaction at both the domestic and international level. The manner in which international institutions affect state actors' policy choices at the domestic level depends on the way they are configured. In other words, the structure of an international institution can determine what policies a state will be able to make. State actors may have to choose policies that they otherwise would not because they have committed to abiding by international institutions.

The policies state actors choose in order to abide by international institutions will have differentiated effects across organizations within domestic political economies. As those effects will benefit some organizations and cost others, those policies will lead to political conflict. In the case of a monetary regime, states must adjust their domestic monetary and economic policies in order to maintain the value of their currencies within the agreed-upon exchange rate bands. The way states adjust those policies will impact on domestic organizations (economic and political interest groups, firms, unions, political parties, etc.) either to their substantive benefit or to their detriment. If the state chooses to lower inflation to meet the demands of the monetary regime, that may negatively impact on labor by deflating the economy and causing unemployment. On the other hand, if the state lowers inflation it may benefit those firms that compete on the international market by keeping them price competitive. Thus those organizations which gain or stand to gain substantive benefits from state policies related to international institutions will have an interest in supporting the state against those which oppose the state because its policies cost them substantively.

As organizations realize over time that other organizations either share common interests or at least prefer the same outcomes but for different reasons, those organizations will likely begin to cooperate to achieve those commonly desired goals (Riker 1962). Thus organizations will form policy coalitions. In some cases, policy coalitions may consist of state organizations only, or in

other cases a coalition may consist of both state and societal organizations. The mix of state and societal organizations in the coalition will depend on the interests of the organizations but also the institutions of policy making. The institutions of policy making will determine which organizations, be they state or societal organizations, can have a say in policy making.

In situations concerning policy choices toward international institutions, coalitions will not always be inclined to stop adding new organizations when they have reached a minimum winning size. Two factors account for this. First, the gains to be had from the shape of international institutions is not always clearly zero-sum for the organizations in the coalition. Also, the coalescing organizations will probably often have difficulty in perceiving what size coalition is big enough to get its way in policy making.

How can we tell which coalition will achieve its policy goals? Several attributes of a coalition (state actors included) contribute to its ability to determine policy: the size of the coalition, its political or economic resources, its degree of organizational efficiency, and its strategy choices. These attributes will be translated into bargaining power vis-à-vis other coalitions. Changes in relative bargaining power, be it an increase in economic or political strength, will be translated into an increased ability to influence government policy (Becker 1983).

An Institutionalist Model of Policy Dynamics

The model of policy making developed here takes the institutions of policy making as its starting point. The model, which builds on the thinking of the "new institutionalism" (see Knight 1992; March and Olsen 1989; North 1990; Steinmo, Thelen, and Longstreth 1992) takes institutions to be crucial variables in determining political outcomes. The interests and power of various organizations and coalitions of organizations cannot alone account for policy choices. Policy choices are also constrained by the institutions of the polity; some are precluded by the rules of the domestic political game. Thus any account of the relationship between international rules and domestic politics must take into account how domestic rules shape the field of political play. Institutions set the boundaries of what is possible by precluding certain courses of action for political actors. Therefore, the way institutions are configured will tell us a great deal about what to expect in terms of policy dynamics. Domestic political institutions, which vary across countries, will determine who has a say in policy making. Knowing who has a say in policy can tell us a great deal about how much variation in policy to expect.

The model developed here has two aims. The first aim is to create a typology

of policy-making systems which will yield predictions about policy dynamics; the second is to identify the mechanism of policy change. The model created here is meant to explain the patterns of policy dynamics found in certain domestic institutional settings. The model does not explain why specific policy changes occur. Specific policy changes are explained by referring to what domestic actors expect to get from policy change and whether they are able to get their way.

Before getting into the details of the model, a word must be said about the dependent variable, policy dynamics. This is a variable that does not have a standard method of operationalization. But it is necessary to establish what is meant by continuous or discontinuous policy in order to create a generalizable framework for understanding policy continuity across cases. Continuous policy will be taken to mean policy that exhibits a lack of change across time and does not contradict the objectives of earlier policy. So continuity implies internal coherence and stability around a central tendency. For purposes of this study, policy that does not vary in its central objectives will be considered continuous policy. Obviously then, discontinuous policy is policy that exhibits frequent changes in the given issue area.

The next step is to identify the variables that cause policy discontinuity. This means pointing out those variables that will shape the way policy is made. Domestic political institutions, that is, the rules of the political process, are crucial constraints on what policy makers can or cannot do to achieve their goals. Two institutional variables are particularly important for determining the consistency of policy: the number of state decision makers with *independent* decision-making authority and the type of access societal organizations have to the policy process. How these variables are combined within any given policy area will determine whether that policy area is characterized by continuity or discontinuity.

The number of state decision makers who can shape policy is important to policy continuity, in that it establishes the likelihood of multiple viewpoints being represented, and contested, in one policy area. One can assume that state actors do not all have congruent interests concerning policy issues. Part of the reason for that is that different state organizations have inherently different organizational interests. Where one sits in the organizational structure of the state will determine what one wants from policy.[3] Also, as policies will have differentiated effects for state organizations, state organizations will want different policies. All else being equal, if there is only one policy maker involved in policy over time, one can expect a greater likelihood of continuity in policy. But if there are two or more policy makers who have a say, policy will be more likely to be marked by discontinuity. Thus the greater the number of state orga-

nizations involved in a policy issue area, the greater the likelihood that those state organizations will vie for different policies, leading to a tendency toward discontinuity. The more cooks who have a hand in making the soup, the more likely they will argue over the recipe, changing it over time.

The second institutional variable, the type of access that societal organizations have to the policy process, is equally crucial in determining policy continuity. I would identify three basic types of access systems that societal organizations have to policy making. The first I call corporatist. A corporatist system is one in which societal organizations have access to the policy-making process from its initial stage and the societal organizations play a central role in shaping policy. Both state and societal organizations have veto power over policy initiatives. In this system, societal organizations, in conjunction with state decision makers, themselves are the initiators of policy. In a corporatist system of societal organization representation, only a small number of organizations will be given access to the policy-making process. Societal organizations outside of the corporatist system are effectively voiceless. This type of institutional arrangement will lead to more consistent policy as societal organizations will constrain what state decision makers can do from the start of the policy-making process. Also, because the number of societal organizations is very small, they will lend coherence to the process.

The second type of access system for societal organizations is what I refer to as constraining. A constraining access system is one where societal organizations do not have direct access throughout the policy-making process. Instead, in a constraining system, societal organizations can introduce themselves into the process once state decision makers have initiated a policy. In other words, in a constraining access system, societal organizations react to state policies; they do not initiate the policies themselves, but mobilize to either support or block policy initiatives made by the state. This type of access system will lead to policy discontinuity, since the policy path is actually subject to two processes of bargaining over the final shape of policy, the first being between the state decision makers, the second being between state decision makers and societal organizations. This disjointed manner of making policy means policy will have a great tendency to be discontinuous.

The third variety of societal organization access system is to be known as a "no access" system. In this type of system, societal organizations have no say in the shaping of policy. State decision makers have fundamental autonomy from societal organizations, which are either poorly mobilized or simply not granted access to the policy process. This type of system will produce a tendency toward continuous policy, given that state decision makers do not have to take into account the interests of societal organizations at any stage in the

Table 1.1 Model of the Institutional Sources of Policy Continuity

Number of State Decision Makers in the Policy Issue Area	Access of Societal Organizations to the Policy Process		
	corporatist	constraining	no access
Low	consistent	inconsistent	consistent
High	consistent	inconsistent	inconsistent

policy-making process. Societal organizations simply fall out of the picture of influence over the policy process.

Having described how these variables on their own affect the tendency toward policy continuity or discontinuity, the next step is to determine how they will affect policy in tandem. It is necessary to look at the independent variables in tandem as they are institutional traits that coexist in every political system. Since they cannot logically be dealt with separately to predict policy continuity, they must be combined. Table 1.1 gives the possible combinations of the independent variables and the predictions of policy consistency/inconsistency produced by the logic of the model.

The variable combinations will be discussed from left to right, starting with the top row. The combination of corporatism with a low number of state decision makers yields the prediction of policy consistency. This prediction results because each of these variables on their own will contribute to policy continuity; combined, they only reinforce the tendency toward continuity. The second combination, a constraining societal organization system and a low number of state decision makers, produces a prediction of policy discontinuity because of the primary effect of the constraining societal organizations. The societal-organizations variable will have primary effect because a low number of state organizations on their own may produce continuous policy, but when they are then constrained after launching their policy, the result will then be changed policy. The third combination on the top row, the low number of state decision makers and societal organizations having no access to policy making, leads to the greater probability of continuous policy. This prediction is made because on their own a small number of state decision makers leads to continuous policy. As societal organizations have no access to the policy-making process in this combination, the state decision maker variable is the only one that affects the prediction.

In the second row, first square, the prediction of a greater likelihood of continuous policy is made, even though there is a high number of state decision makers, because of the stabilizing effect of the corporatist system of societal

Table 1.2 Model of Institutional Sources of Policy Continuity: Examples of Monetary-Regime Policy-Making Institutional Arrangements

Number of State Decision Makers in the Policy Issue Area	Access of Societal Organizations to the Policy Process		
	corporatist	constraining	no access
Low	Sweden consistent	Britain inconsistent	France consistent
High	Switzerland consistent	Germany inconsistent	U.S. inconsistent

organizations. Essentially, the many decision makers lose their independence to make policy as they may want. The few societal organizations will constrain the many state decision makers from the start of the policy process to the end, lending the process its stability. In the second box, discontinuous policy is predicted. In this case, both variables will contribute to policy discontinuity. Numerous state decision makers on their own would produce discontinuous policy, but when they are then constrained after initiating policy, the discontinuity of their policies is only magnified. Finally, there is the combination of a high number of state decision makers and societal organizations with no access to the policy-making process. As a high number of state decision makers on their own will produce a greater likelihood of discontinuous policy, and this is the effect when societal organizations have no access, policy discontinuity will more likely result.

The next step in deriving a hypothesis from this model is to determine where Germany's monetary-regime policy fits into this schema.[4] I argue that Germany's monetary-regime policy area falls under the category of a state with a high number of state decision makers and societal organizations having a constraining effect on policy making (see Goodman 1992; Henning 1994; and chapter 2 herein). Germany's policy-making institutions concerning policy toward international institutions is portrayed in Table 1.2. Other countries' policy arrangements in the same issue area are added for reference.[5]

This means that there is a large number of state and societal organizations involved in the policy-making process. Because of this large number of organizations involved, coalitions of state and societal organizations should form in order to try to shape policy. Unlike the Marxist model, the institutionalist model of German policy making does not assume that there is a static coalition between the German state and German capital. Because of the distributive

effects of monetary-regime policy, there is likely to be conflict *between* state organizations and societal organizations, including capitalist organizations.

Plan of the Study

This book examines four episodes of German policy making toward European monetary institutions. The episodes to be studied are the creation of the EMS, the creation of the Franco-German Economic and Finance Council, the policy toward EMU, and the institutional transformation of the EMS in the 1990s. These four cases were chosen for two reasons. First, they are the most important episodes of institutional creation and change in the process of European monetary integration since the first oil crisis. Second, these cases represent very different types of institutional arrangements. The creation of the EMS represented the establishment of an international monetary regime. The Franco-German Economic and Finance Council is an international decision-making body. EMU concerns the creation of a supranational monetary system. Finally, the transformation of the EMS is an example of a significant change in an international monetary regime. The four episodes are presented in chronological order to illustrate the dynamics of German policy and to provide the temporal context in order to understand the cases. These four episodes are studied to explore the patterns of policy dynamics across all four cases and to determine if the same factors would account for the policy pattern across the cases. Thus the book is not a purely descriptive or inductive study of German policy, but a focused analytical exploration of German policy toward European monetary institutions.

The study is divided into seven chapters. The chapter that follows this introduction presents an introduction to the organizations and institutions of the German political economy which are relevant to monetary-regime policy making. The chapter begins by exploring the basic formal and informal institutions that constitute the German policy-making paradigm. The remainder of the chapter is devoted to examining the interests, policy preferences, and power of the Federal Republic's state and societal organizations that have an interest in monetary-regime policy making.

The next portion of the book is devoted to exploring the dynamics of German policy toward European monetary institutions. Chapter 3 explores the German policy toward the creation of the European Monetary System. The fourth chapter explores German policy toward the Franco-German Economic and Finance Council. The fifth chapter deals with the German policy toward the European Monetary Union initiative. The sixth chapter examines German

policy toward the transformation of the EMS in the 1990s and investigates why German policy changed from supporting the EMS status quo to trying to significantly alter that monetary regime. The conclusion is meant to tie together the theoretical and empirical threads of the study. It points to what this study contributes to our understanding of German political economy, European integration, and the links between international institutions and domestic politics.

2 The German Monetary Paradigm: Actors, Interests, and Institutions

When there are tensions between our domestic responsibilities and our international ones, of course we decide for the internal ones.
—Hans Tietmeyer, Vice President of the Bundesbank, 1993[1]

Policies and political outcomes in any polity are a function of the interests, strategies, and power that actors use to achieve their goals within a given institutional framework. The aim of this chapter is to identify the actors and institutions within Germany that shape German policy toward international monetary regimes. By identifying the players and rules of the German foreign monetary policy-making paradigm, we can better understand the dynamics of changing German policies toward European monetary institutions.

Institutional Principles of the German Monetary-Regime Policy Making

The institutions of Germany's policy making toward international monetary regimes are characterized by the fragmented nature of German state responsibility and the constraining system of access afforded societal organizations. There are several state organizations with independent policy-making authority concerning international monetary regimes. Independent policy-making authority means that each of the state organizations involved in making policy toward international monetary regimes can have a say in that policy, from its initiation to its implementation. It also means that each of the organizations can publicly articulate their own policy preferences throughout the policy-making process. This institutional dispersion of authority allows that there can actually be several German policies toward international monetary institutions existing simultaneously.

State organizations frequently depend on coalitions with one another and with societal organizations to achieve their policy agendas. While it may seem

surprising that the legally independent Bundesbank would also depend on political coalitions to arrive at its policy goals, coalition building is an important facet of the Bundesbank's political strategy.[2] It meets frequently with state organizations, as well as representatives of societal organizations that have a stake in monetary issues. This is not only a way for the Bundesbank to receive input from the organizations that are interested in the shape of monetary policies, but it is also a way for the Bundesbank to weigh what is politically feasible or opportune, and to garner support for policies that will likely face opposition.

It is important to note that German policy toward international monetary institutions is not corporatist in its conception. German societal organizations play a constraining role in international monetary regime policy; they do not participate in policy making from the onset of the process. Policy making toward international monetary institutions is an ad hoc process. There is no procedure for bringing societal organizations into the planning stages of policy in this issue area. Instead, German societal organizations introduce themselves into the policy process after the policy has already been proposed. But because the societal organizations that are interested in Germany's participation in international monetary regimes are so large and powerful, their ability to influence policy is tremendous. The key issue is at what stage in the policy process they exert that influence. So instead of participating in *formulating* policy toward international monetary regimes, societal organizations are important agents of *changing* that policy.

The German State Actors

The relevant state organizations in matters of international monetary regime policy are the Chancellory, the Foreign Office, the Ministry of Finance, the Ministry of Economics, and the Bundesbank. The Bundesbank and the Finance Ministry are the two state organizations directly responsible for German monetary policy. The Bundesbank sets domestic monetary policy and the Finance Ministry is in charge of Germany's exchange rate policy and monetary diplomacy as well as being integral in the economic policy-making process. The Chancellory is a part of the international monetary policy-making paradigm because of its central role in setting the parameters of Germany's foreign monetary relations. The Economics Ministry can play a role in German monetary regime policies because of the importance of the individual who holds that portfolio. The Foreign Office plays an important role because of its part in shaping the Federal Republic's foreign policy that touches on monetary issues.

The German parliament plays a limited role in shaping policy on foreign

monetary issues and ratifying international monetary agreements. The parliament's role in foreign monetary affairs is minor, as that policy is most often made by decree and is handled largely by the ministerial bureaucracies (Chancellory, Foreign Office, and Finance Ministry) and the Bundesbank (Henning 1994; Kreile 1978). Legislation related to international monetary issues is generally worked out by the ministries and then handed to the Bundestag, the directly elected lower house. Bundestag committees, which are structured along ministerial lines, handle bills when they are proposed. The bills passed down by the ministries have already been through the process of decision making at the ministerial level, and by the time they get to the committees the room for contention is limited (Hancock 1989). The Bundestag committees, which have close ties to the ministerial bureaucracies, are comprised of legislators who view themselves more as policy specialists than as publicity-oriented politicians. The committee sessions are more reminiscent of meetings of the board than political affairs, as only 1 percent are open to the public. Furthermore, the opposition in the Bundestag generally tries to exert its influence on policy legislation more through quiet prodding than by boisterous opposition. Despite the representation of at least three parties in the Bundestag since the founding of the Federal Republic, it is quite common for bills to be passed unanimously or with an overwhelming majority (Katzenstein 1987, 43). The Bundesrat, the upper house of parliament that represents the Länder, plays a much less significant role in legislation, unless it pertains directly to Länder issues. Thus in issues of foreign monetary affairs, the Bundesrat plays no significant role.[3]

In sum, the crux of policy power over international monetary issues in the German state lies with the chancellor, the ministerial bureaucracies, and the Bundesbank. While the policy preferences of some ministries, such as the Chancellory, the Foreign Office, and the Ministry of Economics, vary depending on which party holds the portfolio (this is less true with the Finance Ministry), one can point to the policy responsibilities of the various state organizations to gain an idea of what policies they will likely support.

The Chancellory

The Federal Republic maintains a parliamentary system of government with the federal chancellor as the chief executive. The responsibilities of the chancellor include nominating ministers, determining the internal organization of the government, coordinating the work of the cabinet through the chancellor's office, and formulating the policy guidelines of the government (Katzenstein 1987, 22). The chancellor is responsible for the political and economic health

of the country as well as its foreign policy. The postwar German democracy has been referred to as a "chancellor democracy" because of the power the federal chancellor may bring to bear in exercising political leadership. While this notion of chancellor democracy was coined in the days of the Adenauer chancellorship, the heyday of the German chancellor's power, the Chancellory maintains the greatest power of any single organization of the German state. But that power is still relatively limited compared to other European executives. The chancellor depends in large part on his ability to line up other state organizations, such as the ministries, not to mention the Bundesbank, in order to pursue his political agenda. This circumstance has led one student of German government to comment that "government in the Federal Republic of Germany seems characterized by a considerable dispersion of executive power" (Mayntz 1980, 139).

While the foreign monetary policy preferences of the German chancellor depend in large part on who occupies the office and which party he represents, the general interests of the chancellor are based on a relatively simple logic. First of all, the chancellor has the broadest set of policy purviews of any single political figure in the Federal Republic; this means that the chancellor must balance the various issues that capture the German policy agenda and arrive at a policy mix which not only attempts to find the best solution to all problems but also ensures the chancellor's own political viability, both within the German legislature and for the next election. The chancellor's most consistent interests in the domestic political economy have been to maintain economic growth, generate employment, and keep inflation low. The prioritization of those issues depends on the party holding the chancellorship. Social Democratic chancellors are expected by their constituents to tackle unemployment and economic growth, while Christian Democratic chancellors are entrusted more with handling inflation and economic growth (Anderson 1995).

There is a great degree of continuity between German chancellors' domestic and foreign political-economic interests. Helmut Schmidt once said: "For years our foreign policy has been at the same time our economic policy" (Hanrieder 1989, 221). What Schmidt meant by that statement was that German foreign economic and monetary policy was tied in almost all ways to German domestic politics. This is evident in the consistent set of broad foreign economic and monetary policy goals pursued by all German chancellors since 1949, chief among them the increased economic and monetary ties with France, particularly through means of European integration, and maintaining good economic and monetary relations with the United States. These foreign policy interests are greatly related to domestic German economic interests. Both France and the United States are not only important political and mili-

tary allies but also major markets for German exports, and promoting closer economic and monetary ties makes perfect sense for a country which depends on exports for nearly half of its GNP.

The Ministry of Economics

The basic interest of the Ministry of Economics is the continued economic health of the country, defined as economic growth, increased employment, and low inflation. Its priorities, like that of the chancellor, depend on the party which holds that portfolio. Since the mid-1970s, the Free Democratic Party (FDP) has held the Ministry of Economics portfolio and has pushed for policies that prioritize private-sector-led growth with low inflation. The Economics Ministry's chief foreign monetary policy interest is for monetary arrangements that facilitate German exports. But the actual foreign monetary policy role of the Economics Ministry is negligible. Economics ministers generally do not take part in international negotiations or summits related to international monetary institutions, such as the G-7 meetings or EU forums.

The ministry's importance has declined substantially over time. The Ministry of Economics was the most important state organization in the formulation of economic policy in the first decade of the Federal Republic. The ministry was charged with formulating the government's economic policy under the broad guidance of the chancellor (Smyser 1993, 44). It was Economics Minister Ludwig Erhard, and not the chancellor, Konrad Adenauer, who was responsible for leading the Federal Republic's economic recovery after the war. The Economics Ministry was the primary policy conduit for the organizations of industry, labor, and other organizations to the German government (Smyser 1993, 45). But the power and responsibilities of the Ministry of Economics were curtailed in the 1960s when the Office of Money and Credit was moved from the Economics to the Finance Ministry. As the policy power of the ministry has waned since the late 1960s, interest organizations have increasingly turned to the Chancellory, Finance Ministry, and the Bundesbank to exert influence over monetary regime policy.

Despite its decreased responsibilities, the ministry can still play a role in the formulation of policy. A great deal of the power of the ministry depends on the importance of the individual who holds the post of minister of economics. For example, when the prominent FDP politician Otto Lambsdorff held the post in the late 1970s, the importance of the ministry increased. Lambsdorff's power came not so much from being economics minister as from being a leading figure in the FDP; in other words, the Chancellory and other Social-Democrat-held portfolios had to heed Lambsdorff or face serious discord within the coali-

tion. For this reason, Lambsdorff was able to seriously constrain the coalition's policy choices. But when the economics minister is a less important political figure, as was the case with Jürgen Möllemann in the late 1980s, the power of the ministry is diminished.

The Ministry of Finance

The Ministry of Finance is the state organization, along with the Bundesbank, responsible for the Federal Republic's financial and monetary affairs. It has become the most important organization in the German government in the formulation of finance and economic policy. The Ministry of Finance, or more specifically the minister of finance, has also become the Federal Republic's major representative at international monetary forums. For example, when the Federal Republic sends representatives to G-7 meetings concerning monetary issues, it is the minister of finance who goes. The Ministry of Finance is responsible for the Federal Republic's exchange rate policy; thus foreign monetary policy is a shared responsibility with the Bundesbank, which formulates interest rate policy and intervenes in foreign currency markets.

The ministry's primary policy mandate is price stability. Because of that interest, it persistently prefers fiscal and monetary policies which do not promote rapid or large-scale monetary expansion. This emphasis on price stability over economic expansion has led to conflicts between the chancellor and the minister of finance, even when they have been from the same party.[4] As the Finance Ministry is concerned with Germany's financial stability and well-being, the ministry favors international agreements which protect the interests of German domestic monetary stability, since low inflation is viewed as crucial to German financial health and competitiveness.

The Ministry of Finance has been held since the 1960s by the dominant party in the coalition. Because the major coalition partner controls the Finance portfolio, they tend to promote that ministry to boost its visibility. This ministry has very strong ties with the Bundesbank and the German banking community which persist beyond changes in the party in power.[5] Because of the wide policy purview assigned to the ministry, and its well-developed ties to the Bundesbank as well as banking and industry organizations, it is a very formidable organization in German policy making toward international institutions.

The Bundesbank

The Bundesbank, established in 1957 by the Bundesbank Law, is one of the most autonomous central banks in the world. The Bundesbank has taken on an

importance in the German political economy which rivals that of the federal government. Because of its control over monetary policy and its legally protected autonomy, the central bank has tremendous influence over the course of the German economy as well as the political fortunes of the politicians in power.

The central bank is mandated by the Bundesbank Law to perform two central functions: first and foremost to maintain the stability of the German currency and secondarily to support the government's economic policy. In practice, the Bundesbank clearly has taken the first function as its overwhelming priority, often forsaking the government's economic policy in the name of fighting inflation (Kennedy 1990). Because of the historical record of German governments meddling in monetary policy and sparking inflation, the Bundesbank views its autonomy as crucial to maintaining price stability.

The Bundesbank's fixation on price stability is a product of the German experience with two bouts of severe inflation, in 1923–1924 and 1945–1948, which eradicated the savings of the majority of Germans. The hyperinflation of 1923–24, brought on by reparations after the First World War and government meddling in monetary policy to finance its debt, has done the most to create the Bundesbank's inflationary ethos. The memories of over 10,000 percent annual inflation rates during that period, which made scores of Germans destitute, have been handed down over the generations. Likewise most older Germans can remember the immediate postwar years when their Reichmarks were rendered worthless and economic transactions were done by barter. It is the memories of these times that have instilled in German central bankers a profound fear of inflation, a fear which is shared by the majority of the German population. No matter what the political context has been, the Bundesbank has maintained a highly consistent organizational ethos that abhors inflation.

Federally structured, but with its decision-making organ located in Frankfurt, the Bundesbank is a federal agency legally independent from the German government. The Bundesbank was not a totally new creation in 1957 but the continuation of the Bank deutscher Länder (BdL), which was established by the American and British occupation authorities in 1948 and modeled on the American Federal Reserve.

The institutional design of the Bundesbank, with its rather large and cumbersome executive decision-making body, the Central Bank Council (CBC), as well as its location in financial Frankfurt rather than political Bonn speak of the fears of those who constructed the Bank deutscher Länder and then the Bundesbank. The concern was that a centralized bank with close ties to political elites would endanger the autonomy of the bank and thus German price stability. The CBC consists of two tiers; the Directorate and the presidents of

the Land central banks (LCBs).[6] The Directorate consists of the president, the vice president, and up to eight other members. They are nominated by the government and appointed by the president for a period of normally eight, but not less than two years. The present nine LCBs send their presidents to Frankfurt every two weeks to meet with the Directorate in the CBC session to make Bundesbank policy.[7] LCB presidents are nominated by the Länder and appointed by the federal president for the same tenure as Directorate members. In voting on policy decisions, the rule is one man, one vote. This means that the Bundesbank's president does not have any more power in formulating German monetary policy than the president of an LCB. Students of the Bundesbank have noted that the LCB presidents, the majority of whom are less in tune with politics in Bonn than Directorate members, dominate Bundesbank policy and account for its unflinching fight against inflation (Kennedy 1990; Marsh 1992).

The Bundesbank wields tremendous power to shape the course of the German economy. The Bundesbank has several very important policy instruments at its disposal for controlling the German monetary situation. The most important of these is its responsibility to set discount and Lombard rates. Discount rates, the most important Bundesbank monetary policy instrument, are the interest rates at which the Bundesbank loans money to banks. Lombard rates, which have a less important effect on economic activity, are the rates used for short-term funding and overnight bank deposits. But in terms of controlling the German money supply and inflation, the discount rate is by far the Bundesbank's most important tool (Deutsche Bundesbank 1989, 44–79).[8]

While the Bundesbank's domestic monetary responsibilities are clearly defined, the central bank has an ambiguous role to play in international monetary regime policy. The Bundesbank does not have a de jure policy competence in international monetary diplomacy. But because international monetary regimes directly affect the Bundesbank's domestic policy competence, the bank has a keen interest in this policy area. Thus there has been something of a struggle at times between the central bank and other state organizations over what role the Bundesbank should have in making policy toward international monetary regimes. The Bundesbank has almost always been given a say in such policy making because it is closely linked to its legally established policy purview.

Whereas the Bundesbank has been careful to appear above the fray of electoral politics, its great importance for the economic and political destinies of many Germans naturally makes the bank a very political organization. It is important to note that the Bundesbank's autonomy is not protected by the Basic Law (the German constitution) but is guaranteed only by the Bundesbank Law of 1957.[9] Aware that its autonomy could be diminished by a change in that law,

the Bundesbank maintains a balance between its own interests and the boundaries of what it feels will be accepted by German public and elite opinion. Goodman (1992, 59) says of the Bundesbank's balancing act:

> Above all, the Bundesbank has been cognizant of the fact that its independence ultimately rests on societal support, and it has taken that support into account in fashioning monetary policy. For this precise reason, the Bundesbank has sometimes given ground—that is, it has acceded to pressures for greater monetary expansion. In general, the Bank has done so only when two conditions have been met: first, when monetary expansion enjoyed overwhelming support within West Germany and abroad, and second, when pursuit of such a policy did not threaten to ignite domestic inflation.

The Bundesbank guards its autonomy as if it were under constant threat. A crucial part of maintaining the stability of the deutsche mark concerns the credibility of the Bundesbank's commitment to defending the currency's value. That credibility has a great deal to do with the *appearance* that the Bundesbank does not bend to outside pressures which may threaten its commitment to price stability. As the confidence in the future worth of the deutsche mark is a central factor in its present value, the Bundesbank is ever wary that it seems susceptible to any external constraint or influence that could potentially move it from its stability goal.

Although the Bundesbank is legally responsible only for German monetary policy, the central bank maintains a keen interest in the government's economic policies, the reason being that these policies have a direct bearing on the rate of inflation. The Bundesbank has consistently used its position as the guardian of the deutsche mark to warn the government when it believes the government's economic policies threaten to increase inflation. The Bundesbank also comments on wage agreements, urging restraint when it views the agreements to be too generous and thus inflationary.

There are four ways in which the Bundesbank attempts to get its message across to the German government as well as other organizations of the German political economy. First, it has set annual monetary targets since 1974.[10] The monetary target sets out what the Bundesbank considers a tolerable level of price increases or money supply growth for the coming year. This is meant to make it clear to all interested parties what the framework for monetary policy will look like for the near future (Deutsche Bundesbank 1989, 95). Second, the Bundesbank issues public statements intended to make as clear as possible what the bank thinks about policy. Third, Bundesbank officials summon organizations to the headquarters in Frankfurt in order to discuss possible policies

and to seek political support for those policies. The Bundesbank has developed particularly close ties with banking and industry organizations, as they share its anti-inflation ethos and perceive a great stake in the central bank's policies. Fourth, the Bundesbank uses its monetary policy instruments to signal its wishes. The central bank occasionally increases interest rates or at other times delays in lowering them to signal its displeasure with government policies or wage settlements between labor and industry that it believes to be inflationary.[11]

The Bundesbank's primary goal in terms of Germany's monetary regime policy is the defense of the deutsche mark's domestic value. The Bundesbank is less concerned with exchange rate stability if that means having to intervene in international currency markets to maintain the value of the deutsche mark vis-à-vis other currencies. The reason for this reluctance to engage in international intervention stems from the fear of losing control of the domestic German money supply because of international commitments.

One of the greatest perceived international threats to the Bundesbank's goal of domestic price stability was the Bretton Woods monetary regime. Bretton Woods created a situation in which Germany became a victim of its own economic success. As the Bundesbank was able to maintain domestic German price stability and thus make German products internationally competitive, greater amounts of funds flowed into Germany, creating inflationary pressures. As the regime fixed the value of the deutsche mark, the option of revaluing the deutsche mark was a difficult political maneuver. The Bundesbank had to struggle within the confines of the monetary regime to maintain German domestic price stability, which by the late 1960s and early 1970s was threatened more and more by capital outflows from the United States. Thus, when the Bretton Woods regime collapsed in 1971, the Bundesbank was relieved to see the end of what it felt to be a dangerously confining set of international institutions (Emminger 1975). The experience with the Bretton Woods regime instilled in the Bundesbank an antipathy for international monetary institutional arrangements, as they could possibly narrow the range of options available to contain inflation (Hanrieder 1989).

The Foreign Office

The Foreign Office has played a significant role in setting German foreign policy guidelines which have substantially affected aspects of policy toward monetary regimes. Thus the foreign policy role of the Foreign Office has meant that its policies often overlap with those of the Ministry of Finance and the Bundesbank. This intersection of policy areas has often led to conflict between the Foreign Office, which values improving political ties between Germany and

its principal allies, above all France, and the stability-minded Finance Ministry and Bundesbank, which are much less interested in the political aspects of foreign policy.

The Foreign Office has been the foremost proponent of European monetary integration among German state organizations. Hans Dietrich Genscher, the FDP foreign minister from 1974 to 1992, was a very strong proponent of European integration because of his belief in the importance of French-German cooperation to lessen the potential tensions between these historic enemies. By forging closer ties with France, the Federal Republic would be able to increase its contacts with Central and Eastern Europe, without raising suspicions of Germany's going its own way (Hanrieder 1989). Because European integration was obviously intertwined with German economic and monetary interests, the Foreign Office was a crucial player in Germany's external position on matters related to monetary policy.

The Foreign Office has traditionally been a powerful organization in the German state structure, not only because of its policy purview but also because of the pivotal political role played by the party which holds that portfolio. Since 1974, the post of foreign minister has been held by the leader of the Free Democrats, Genscher from 1974 to 1992 and Klaus Kinkel from 1992 to the present. Thus, the foreign minister has been able to parlay his domestic political clout into power to greatly influence if not outright shape the Federal Republic's foreign policy, particularly when it comes to contentious issues such as European integration.

Organizations of the Private Sector

The primary characteristics of the German private sector are its high degree of organization and centralization. Almost all segments of German private society are organized into some form of interest organization. Economic interest organizations are hierarchically structured, culminating in peak associations which represent whole sectors of the economy or segments of society at the national level. The vast majority of these well-organized peak associations are headquartered either in Bonn, Cologne, or Düsseldorf.

Decision making in the peak associations is almost uniformly top-down in nature (Berghahn 1986; Blümle and Schwarz 1985). Although members of local or more interest-specific associations may have some input on matters pertinent to their sectoral organization, when it comes to matters of national policy, the national level peak associations take positions and decide on strategy, taking what they consider to be the general interests of their constituent members into consideration but often with minimal actual input from those mem-

bers (Triesch and Ockenfels 1995). Individual firms or even regions of Germany have little chance of influencing policy, except in exceptional cases. They must depend on their peak association to a large degree to use channels between that association and policy makers.

Peak associations depend on forming coalitions with each other and with state organizations in order to achieve their policy aims. The logic of these coalitions is based on the assumption that the larger the coalition, the more powerful will be its impact on the policy process. A senior Federation of German Industry (BDI) functionary says this of his organization's general strategy to influence policy: "Our usual mode of operation is to form coalitions with like-minded organizations. We do this because it is so very important to have allies. If an organization is isolated, it has very little chance of being successful."[12]

The channels of communication between the peak associations and state organizations in policy making are of a largely informal nature. In other words, there are no codified rules for how peak associations are to be included in the international monetary-regime policy-making process. Lines of communication have been established to consult the peak associations on issues that affect their interests. The channels of communication consist of informal and impromptu meetings between state and peak organization officials.

Peak associations focus their efforts to influence policies relevant to monetary issues on the executive and the Bundesbank and generally bypass the German legislature. The outcome of political conflict over policy is presented to the Bundestag as faits accomplis to be enacted (Kreile 1978, 200). Peak associations go to the legislature to influence policy toward international monetary regimes only when treaties which must be ratified are involved. When representatives for the peak associations do go to the Bundestag to try to influence decision making, they do not target individual legislators or even small groups of legislators but concentrate on influencing party decisions (Sontheimer 1989). The peak association lobbyists most often meet with Bundestag committee members and their staffs. As German parties are well disciplined and usually vote as a bloc, peak associations focus on influencing the leadership of the party in order to sway votes their way. Campaign donations play less of a role in lobbying in the Federal Republic than in the United States because of the stricter limits on such activities in Germany and because the donations are not tax deductible (Smyser 1993, 61). Societal organizations depend on strong and persistent ties with parties to influence legislation (Triesch and Ockenfels 1995).

But the power of the peak associations to influence ministry bureaucracies comes not only from their inclusion in the policy-making process; it is also a

function of the associations' large membership and potential to either reward or punish state organizations. Peak associations reward those state organizations that help their interests in particular policy decisions by providing support for subsequent policy initiatives important to the state organizations.

Peak associations also have the ability to constrain policy makers by threats of punishment. They can mobilize public opinion against politicians as well as withhold their support for policy decisions when they are included in the policy-making process. Because of the large number of politicians with direct organization ties, peak associations can punish politicians by causing dissension within their political party. For these reasons, peak associations have a large amount of power in German policy toward international monetary institutions.

Industry Organizations: The BDI and DIHT

Industry comprises the largest sectoral portion of the German economy in terms of employment (40 percent). German industry has developed a very well organized and financed set of interest organizations which have tremendous political power within the German political economy. The Bundesverband deutscher Industrie (BDI), the Federation of German Industry, is the primary representative organization of German industry in monetary matters.[13] It is the most powerful interest group in Germany because of the importance of the industrial sector to the German economy. The BDI is an umbrella organization comprising thirty-nine sectoral organizations and representing around 95,000 firms. The BDI, which encompasses 90 percent of all industrial firms, is the most important voice for German business (Dalton 1989, 211).

The BDI's prime interest is to help firms thrive. Because the BDI views price stability and unrestricted market access as the keys to that well-being,[14] it is therefore an advocate of a cautionary, yet moderate monetary policy. The BDI prefers exchange rate stability, but not at the cost of domestic price stability. It does not favor devaluations of the deutsche mark if that means that domestic prices increase. As one BDI official has put it: "We do not want to engage in exchange rate dumping to make ourselves competitive. Even in terms of investment in other countries, swings in exchange rates are not that big of a problem."[15]

Industrial firms, working through the BDI, have developed substantial and solid links to the German government ministerial bureaucracy (Braunthal 1965; Berghahn 1985). The BDI directly petitions state organizations, primarily the Ministries of Finance and Economics, and the Bundesbank.[16] The BDI also has strong ties to both the Christian Democrat and Free Democrat parties (see

Braunthal 1965), yet its influence is also substantial when Social Democrats are in power (Smyser 1992, 55).

On some issues, the BDI has suffered from internal conflict because of the heterogeneous nature of its membership. As the BDI encompasses member firms as large as Krupps and as small as firms with a few dozen employees, there are instances when the membership has difficulty arriving at a common position. Large firms within the BDI tend to have a stronger voice in setting the position of the organization than smaller firms, and conflict between larger and smaller firms can weaken the BDI's position in trying to influence government policy. But when the BDI is internally unified, and that is by far the most frequent scenario, the organization is the most powerful societal organization in German politics.

The Deutscher Industrie- und Handelstag (DIHT), the German Chambers of Commerce, is in many ways similar to the BDI yet it is organized in a much different manner. The DIHT, the national umbrella organization of German chambers of commerce, is comprised of sixty-nine regional chambers of commerce which include all firms in Germany as their members. Whereas the BDI is more representative of large businesses, the DIHT is more the voice of medium- and small-sized firms. The DIHT generally has a set of broad interests similar to the BDI. Because of this congruency of interests and overlap in membership, the two organizations often cooperate and exchange information in order to better serve their members.[17] As the representative of German businesses, the DIHT is most concerned with its constituent firms' economic health. The DIHT, like the BDI, sees the source of that economic health in domestic price stability and an unrestricted market.

In terms of foreign monetary issues, the DIHT has much the same interests as the BDI but represents a more general position on issues. The DIHT does not have quite the political clout that the BDI has at the national level, as the former represents an even more heterogeneous group of firms and regional interests and a common position is sometimes difficult to achieve (Katzenstein 1987, 26).

Banking and Savers' Organizations: The BDB, DSGV, BVR, and GSDS

German banks play a very influential role in the political economy of the Federal Republic. Large universal banks in Germany are particularly powerful because of their close ties with German industrial firms (Franke and Hudson 1984; Smyser 1993). Such banks own large portions of and sit on the boards

of almost all major German firms, providing them capital when they need it but also steering those firms in the direction the banks wish to go. Other types of banks, such as savings and cooperative banks, also play an important role in the German political economy, as Germans tend to put their extra earnings into savings rather than bonds or stocks (Symser 1992, 83). This economic power is translated into political power. As the banks can control the destiny of so many of the firms which account for the majority of German employment and also control the financial future of the German public, banks have a large voice in monetary politics (Dyson 1986; Edwards and Fischer 1993; Kreile 1978).

Banking organizations in Germany are based on the type of banking service they provide, be they savings banks, universal banks, or cooperative banks. The most influential German banking organization, and one of the most powerful interest organizations in Germany along with the BDI and DIHT, is the Bundesverband deutscher Banken (BDB), or Federation of German Banks, which represents universal banks. The BDB includes within its ranks the "big three" of Commerzbank, Deutsche Bank, and Dresdner Bank. The banks represented by this organization account for a major share of the financing for large German corporations.

The BDB's major interests lie in the stability of the deutsche mark, general economic growth which impacts on the economic well-being of the firms its members finance, and the free flow of capital which the universal banks can utilize. The BDB generally agrees with the Bundesbank's monetary policies, inasmuch as they are seen as the best defense of the worth of the deutsche mark.[18] Because of the strong ties between German banks and German industrial firms, universal banks maintain a set of foreign policy interests very similar to those of German industrial organizations (Kreile 1978). German banks have also strenuously supported the liberalization of European capital markets, in that they see great gains to be made from the free movement of capital since German banks are relatively competitive and well positioned to corner a large share of the European financial market. The BDB is an extremely powerful organization in the German political economy because of the importance of universal banks, its ties to German industry, and its close relationship with the Bundesbank and Finance Ministry, as well as with portions of the FDP and CDU.

The Deutsche Sparkassen- und Giroverband (DSGV), the German Savings Bank Federation, represents the interests of the Federal Republic's savings banks, a substantial grouping of banks in a country of savers. Savings banks have fewer functions than universal banks and therefore have a more narrow range of interests. Savings banks are restricted to particular regions and are

intended to provide individual loans, mortgage financing, and infrastructure financing for the Länder governments; they are not meant to engage in speculative financing.

Savings banks are interested above all in the stability of the deutsche mark, since inflation eats at the savings of their customers.[19] This interest in price stability means that the DSGV favors the Bundesbank's restrictive monetary priorities. It maintains the foreign monetary policy interest of wanting to safeguard the Bundesbank's autonomy from international monetary intervention, which it fears could threaten domestic German price stability by increasing the money supply. The organization, like other banking organizations, meets regularly with the Bundesbank Directorate to discuss policy issues. When the DSGV does have problems with Bundesbank policy, it avoids the appearance of direct confrontation with the central bank. A DSGV functionary puts it this way: "When we have problems with the Bundesbank we do not commit our complaints to writing. We use more informal channels."[20]

The Bund deutscher Volks- und Raiffeisenbanken (BVR), the Federation of German Cooperative Banks, is the organization which represents Germany's cooperative banks. Cooperative banks were founded to be self-help associations, which are owned by their depositors. The cooperative banks compete somewhat with savings banks for customers, although their customers come overwhelmingly from agriculture and medium-sized businesses (Franke and Hudson 1984, 60). The BVR's interests and policy preferences are more or less congruent with those of the DSGV, although it wields less political influence, as cooperative banks are less numerous and economically important than savings banks.

The Gesellschaft zum Schutz der deutschen Sparer (GSDS), the Association for the Protection of German Savers, is an organization which represents the interest of Germany's financial institutions and is devoted to influencing policy to fight inflation. The GSDS has only one interest: the stability of the deutsche mark.[21] Thus it attacks any government or even Bundesbank policy which could possibly threaten to increase inflation. The GSDS could be said to be even more monetarily conservative than the Bundesbank, since the savers' organization is only interested in protecting the stability of the German currency and is not concerned with economic growth, something which the Bundesbank also takes into account when making monetary policy. The GSDS is also very active on matters of foreign monetary policy. Its overriding interest in that policy area is to avoid any possible constraints on the Bundesbank's room for monetary policy maneuver.[22] Thus the GSDS has been the most vocal opponent of any international institutional arrangement involving the Bundesbank for fear of the Bundesbank's losing control of the domestic money supply. Despite

its small size, the GSDS is moderately influential, mainly due to the importance of savings to most Germans.

Labor: The DGB

The Deutscher Gewerkschaftsbund (DGB), the Federation of German Trade Unions, is the major umbrella organization for labor.[23] It comprises seventeen trade unions organized along industry lines. The DGB and its member unions are very hierarchically organized (Markovits 1986).[24] The DGB is a political umbrella, acting as labor's foremost advocate on matters of economic and monetary policy; the member unions themselves engage in collective bargaining. The unions' positions on monetary issues come from the top and there is little room for grass roots input.

The DGB's main interests are high wages and increased employment for its members. To achieve greater employment for its members, it advocates expansionary monetary policies. The DGB has been one of the Bundesbank's most vocal critics, charging the central bank with contributing to Germany's unemployment.

The DGB's political power in economic and social policy making is substantial, in that 40 percent of German workers are unionized and the federation represents 80 percent of the unionized German labor force. Whereas less than half the labor force is unionized, over 90 percent of all jobs are covered by collective bargaining agreements, giving the union members of the DGB tremendous power. Although Germany has one of the lowest strike rates in the industrialized world, the success of major strikes has demonstrated to German governments and business the power of organized labor.[25] The power of German labor has countervailed, to a great degree, the power of industry groups such as the BDI and DIHT to influence economic policy that affects the interests of the unions. The DGB maintains strong ties with the SPD because of its similar ideological outlook and interests, yet refrains from any formal ties with the party (Katzenstein 1987).

Despite the power of the DGB to affect economic or social policy, the labor organization has had little influence over monetary regime policy. It has only recently begun to take positions on foreign monetary issues.[26] There are two reasons that the DGB has played a minimal role in the monetary policy-making process. The first is that the DGB does not maintain a close relationship with the Bundesbank or the Finance Ministry. While the DGB meets with Bundesbank officials as part of the central bank's pattern of communication with German peak associations, the German central bank has consistently ignored the DGB's demands for a more expansionary monetary policy. A senior DGB official says

of the organization's relationship to the Bundesbank: "We have criticized the Bundesbank because it always cares more about monetary stability than general economic policy. We put employment first. . . . The DGB tries to influence the Bundesbank's monetary policy, but has had little effect. We regularly take positions and we have conversations with the Directorate. But we realize that we are only one element among many."[27]

The reason the DGB has played a minor role in German monetary regime policy centers on labor's perception that its interests in foreign monetary issues have converged with German industry. German labor has generally agreed with the BDI's and DIHT's stances on foreign monetary issues, as what has been good for industry seems to have been good for German labor (Kreile 1978, 203). A second reason why labor avoided foreign monetary policy was its view that it did not directly affect the interests of German unions.[28] Only when the EMU plan was proposed in 1988 did the DGB begin to comment on European monetary integration, arguing in favor of the EMU process. The DGB took a pro-EMU position because it saw monetary union as a means of constraining the Bundesbank, which would otherwise be impossible in the German domestic context.

Agriculture: The DBV

The Deutscher Bauernverband (DBV), the German Farmers' Union, is one of the most cohesive and successful of German interest organizations despite the small size of the agricultural sector in the German economy. Its membership of one million farmers includes about 90 percent of all agricultural producers in the Federal Republic (Katzenstein 1987, 28).[29] The DBV also has an impressive track record in achieving its political goals. It has been able to maintain agricultural prices much above the world market prices and has been able to defend its interests against any substantial political threats.[30]

The DBV's main foreign policy goal has been to support all EU measures which are intended to maintain price levels. The DBV has been an avid supporter of European monetary integration because of the perception that the greater the degree of monetary integration, the more protected German agriculture will be from international price fluctuations. Fluctuations in exchange rates wreak havoc with the Common Agricultural Policy price support mechanisms. Thus the DBV has been the most vocal supporter of international institutional arrangements to maintain exchange rate stability.[31] In the words of a senior DBV functionary: "Economic and monetary integration cannot happen fast enough for us."[32]

The DBV has been successful in dominating German agricultural policy be-

cause of the organization's extremely close ties with the Ministry of Agriculture. That ministry, which is officially named the Ministry for Nourishment and Agriculture, is often derisively referred to as the Ministry for the Nourishment of Agriculture. This protection of agricultural interests has remained constant throughout the history of the Federal Republic.

While the DBV has dominated the agricultural policy of Germany, it has played a much less substantial role in German foreign monetary policy. On foreign monetary policy issues the DBV can exert some minor influence when it takes a strong position because of its ties to the Christian and Free Democrats. The DBV maintains particularly close ties with the Christian Social Union in that farmers form an especially important constituency in Bavaria.[33]

The Political Parties: The CDU/CSU, SPD, FDP, and the Greens

German political parties, like political parties in most industrial democracies, are organizations whose goal is to seek political power so as to affect policy outcomes in the interests of themselves and their constituents. How those interests have been defined has changed somewhat over time or depends on who is in ascendancy in the party, but it is possible to make generalizations about their constituency's major interests and their monetary policy preferences.

The Christian Democratic Union (CDU), Germany's second largest party, is a center-right "catch-all" party which unites conservatives, economic liberals, Catholic social reformers, conservative Protestants, and Catholic workers in a single political organization (Katzenstein 1987, 36). The CDU is a large, decentralized party with several wings, which represent various interests. Because of this heterogeneous membership and interest base, the CDU is a party which formulates its policy positions based on compromises (Schmid 1990).

Despite the heterogenous nature of the CDU, the party can be said to have a generalizable position on monetary-regime issues. The party accepts the state's role in the economy but leans toward less expansionary monetary policies than advocated by the SPD. This means that the CDU generally has a less conflictual relationship with the Bundesbank than does the more expansionary-oriented Social Democrat Party. The CDU's foreign monetary policy interests have remained relatively consistent over time. The CDU is staunchly committed to the European Union, and advocates increased European monetary integration as a means of furthering Franco-German ties, which it views as crucial to maintaining the Federal Republic's good graces in Europe.[34]

The Christian Social Union (CSU) is the Bavarian wing, or more accurately,

sister party of the CDU. The CSU, which has its own party program and congress, stands to the right of the CDU and all other nationally represented parties on most policy issues. The CSU has close ties to the DBV because of the importance of agriculture in Bavaria. The party calls for parsimonious fiscal policies and generally supports the Bundesbank's monetary policies. The CSU maintains a foreign monetary policy agenda that is very similar to the CDU's, although its foreign policy considerations are often more nationalistic than the CDU's. The CSU has at times also been a vocal critic of aspects of European integration, arguing that Germany sacrificed too much of its national autonomy to placate the French.

The Social Democratic Party (SPD), Germany's largest party in terms of membership, is the major left-oriented party in the German party landscape. The only party to survive from the pre–Federal Republic period of Germany, it comes from the socialist tradition but has moved to the center-left since the late 1950s. Although the SPD is much more broadly based than a strictly working-class party, it remains tied to labor's interests. The party favors a more activist government role in the economy than the other major parties, above all to achieve increased employment. The SPD has pressed for Keynesian-style expansionary fiscal policies and has often been critical of the Bundesbank's restrictive monetary policies. There is a great deal of congruency between the SPD's foreign monetary policy interests and those of the CDU (Braunthal 1983; Dalton 1989). It too has been generally very pro-European integration and advocated increased monetary integration. Only recently have some SPD politicians begun to oppose some aspects of European monetary integration because of their unpopularity in the German public (this will be discussed in greater detail in chapter 6).

The Free Democrats (FDP) are the Federal Republic's liberal party. The FDP is a small party with a much narrower core of voters than the CDU and SPD, but it plays a pivotal role in government coalitions, which makes it powerful beyond its size. Because of its key swing role in German governing coalitions, the FDP is able to secure major ministerial portfolios, such as Foreign Affairs and Economics. Most closely associated with the interests of the German business community, it favors a minimum of government intervention in the economy. The FDP is the most free-market oriented of the German political parties and calls for monetary policies which are similar to the thinking of the Bundesbank. The Free Democrats share the same general foreign monetary policy goals as the SPD and CDU/CSU; the major distinguishing nuance is that the Free Democrats are the most vocally pro-European integration of any of the German parties (Dalton 1989).

The Greens round out the major parties of the German system. Created in

the late 1970s from various environmental and peace groups, the Greens have been in the German Bundestag since 1983. The Greens are to the left of all the major parties on most issues. They are most interested in controlling the effects of German industrialization, consumerism, and civil liberties (Hancock 1989, 87). Foremost an environmentally oriented party, the Greens do not constitute a traditional party, in that they are not class based. The party has remained relatively uninterested in foreign monetary policy. The Greens do not represent a coherent set of interests on foreign monetary policy. The main considerations that they bring to questions of European monetary regimes are whether those policies promote democracy or social justice.

The Role of Public Opinion

A potentially important factor in any policy area is the role public opinion plays in shaping the policy debate and constraining policy options. But the role of public opinion varies across policy areas to a great extent. The two major factors that influence whether the public will become a factor in policy making are how or if policy makers present policy issues to the public and to what extent the public is interested in the topic. In some policy areas we have extensive data about how policy makers involve the public and how interested the public is in the policy area. For example, general economic policy is a salient policy issue which attracts a great degree of public interest (see Anderson 1995). But international monetary policy in general is considered a policy area where the public is generally poorly informed and not very interested (Krasner 1978).

Is Germany an exception to this generalization? While some scholars (see Goodman 1992) argue that the public is an important factor in battles between the Bundesbank and the government over the direction of monetary policy, there is no real evidence to show that the German public has followed policy toward international monetary institutions with any consistency. In fact, there is good reason to believe that the public has *not* been interested in this issue until recently.

Several factors account for the lack of public interest in German policy toward international monetary regimes in general, and European monetary institutions in particular. First, the general public does not have the knowledge of international monetary economics to understand what the policies mean. Second, the public has not been aware of the politics of policy-making European monetary institutions. The public has not been aware because the actors which are involved in the making of that policy have not sought to make it aware. Politicians have not sought to make opposition to European monetary institutions an issue to score political points, because there has been a general

consensus both among political parties and between the public and the parties as to the desirability of furthering European integration. Thus while political parties may hope to outdo the other parties by showing their "Europeanness," a mainstream German political party would be very hesitant to try to promote public hesitation about the European integration process. All the major parties are aware how important it is to Germany that it appear a good European neighbor to its EU partners.

The lack of public interest and involvement in policy toward European monetary institutions is changing. Since the signing of the Maastricht Treaty in February 1992, the German public has paid a great deal more attention to European monetary issues, the most obvious reason being the vast changes spelled out in the treaty. European Monetary Union means that the German public will have to give up their beloved deutsche mark for the untested euro.[35]

A factor which has contributed to the public's interest in European monetary politics since Maastricht is the changing strategies of political parties and interest organizations concerning public involvement in the policy debate. Critics of the Maastricht Treaty have attempted to draw the public into the debate in order to constrain the Kohl government's options on monetary union through newspaper editorials and television spots. Proponents of the process have responded in kind. Another contributing factor has been the Social Democrats, who in 1995 broke with tradition and used opposition to EMU as a political weapon against the Kohl government. This has only heightened public awareness of the policy issue.

So to sum up, the role of public opinion in German policy toward European monetary issues has been limited until recently. The public's high regard for the independence of the Bundesbank and the veneration of the deutsche mark were factors which constrained all German government actions in the monetary realm, even when they were not explicitly articulated by the public. But since the signing of the Maastricht Treaty, the German government has become much more sensitive to public opinion, making it more cautious on any policies which may alarm the public. This changing role of public opinion will become evident in the chapters to come.

Conclusion

What has this discussion of institutions and actors that constitute the German monetary policy-making paradigm contributed to our understanding of changing German policies toward European monetary institutions? These changing policies lead us to focus on the Chancellory, the Ministry of Finance, the Ministry of Economics, the Foreign Office, and the Bundesbank as the key

state actors in that policy change. But we must examine the interests and behavior of the banking, industry, labor, and agricultural organizations, as they all have a stake in the shape of European monetary institutions and are crucial to the policy process.

The most important lesson of this chapter is that the fragmented power and policy responsibility of the German state and the constraining nature of German societal organizations means that one would expect German policy toward international monetary institutions to be prone to discontinuity. With so many decision makers involved in policy making and societal organizations having the power to change policy but not initiate it, the factors that would lead to a very dynamic policy are present. The next step is to examine how the nature of German domestic political institutions shapes the dynamics of policy toward European monetary institutions.

3 German Domestic Politics and the Development of the European Monetary System

The European Monetary System that came into being in 1979 was not the monetary regime envisioned by its initiators, German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing. After EC Commission President Roy Jenkins proposed a fixed exchange rate regime for the European Community in 1978, Helmut Schmidt picked up on the idea and convinced Giscard of the idea's merits. Schmidt and Giscard planned for the EMS to be a symmetric exchange rate regime, where all members would have equal currency-market intervention and policy adjustment obligations. But when the EC member states were negotiating the final design of the EMS, the German government changed its position and demanded instead that the EMS be constructed as an asymmetric regime that would place the burden of intervention and policy adjustment on weak-currency countries.

What accounts for the German policy change toward the creation of the EMS? Why would the German government propose a symmetric monetary regime, then change its position and only agree to the EMS as an asymmetric regime? Was the German government trying to trick the other EC members into accepting a German-dominated exchange rate regime? To find the answers to these questions one must focus on two factors. First, one must look to see what distributional considerations motivated the relevant actors. Second, we must explore how the institutions of policy making shaped the way these state and societal actors attempted to realize their goals in determining policy toward the EMS's design.

I argue, from focusing on the two variables mentioned, that the source of the Schmidt government's policy change toward the shape of the EMS's institutions lies in the way policy coalitions between German state and societal organizations were formed. In this salient case of policy change, the German Chancellory made a proposal that, in principle, attracted the support of German banking and industry organizations because of their attraction to the positive benefits from stable exchange rates. This got the proposal off the ground. But the Bundesbank, which shared responsibility for policy toward interna-

tional monetary regimes, was able to form a policy coalition, which forced the Schmidt government to back off from its original plan for the institutions of the EMS because of the potential of that plan to endanger domestic price stability.

The Genesis of European Monetary Integration

When the European Economic Community was created by the Treaty of Rome in 1957, little mention was made of monetary cooperation.[1] But as the process of European integration progressed, monetary cooperation became a focus of discussion. There were two primary reasons why the monetary aspects of integration grew in importance. The first was purely pragmatic; the economic interactions of the EC demanded stable exchange rates. As the Community became more interdependent economically and Community programs like the Common Agricultural Policy (CAP) grew in importance, exchange rate instability raised the costs of transacting and even threatened to halt or reverse the progress of integration. The second reason for European monetary integration was political. Many Europeans felt that one of the best ways to tie the separate states of Europe together politically was to tie them together monetarily.[2] The Europeans looked to cases in history from which to draw examples of how the monetary integration of previously separate political units eventually led to their political unification, German unification in the nineteenth century being the most proximate. Thus the creation of European monetary institutions was seen as a way of linking the states of the EC on the way to European political unification.

The Barre Report of 1969 was the first systematic EC approach to monetary issues. It argued that increasing international monetary instability would create problems for the Common Agricultural Policy and the working of the customs union (Giavazzi and Giovannini 1989, 11). The Barre Report and European monetary integration were given a political impetus at the 1969 Hague summit, when the German Chancellor, Willy Brandt, forwarded plans to create a European Monetary Union (EMU). Brandt's call for EMU was greeted with caution by both the Bundesbank and the Ministry of Finance out of the fear that it could tie Germany to its inflation-prone neighbors. Brandt took the initiative at the summit to demonstrate his government's commitment to West Europe, which was important in light of his daring *Ostpolitik*. He also took the initiative out of a belief that Europe needed to be strong in the face of weakening U.S. leadership. Brandt believed that the creation of strong European monetary institutions would bind the Community together politically and economically, and forestall a crisis in the CAP, the centerpiece of Franco-German cooperation (Tsoukalis 1977, 85). This was a substantial departure

from the previous German position, which had been to look to the Bretton Woods institutions as the key to international monetary stability.

Brandt's initiative received a warm welcome from the other EC member states, in particular from France, which had the most to lose from disturbances in the CAP. The Hague Summit spawned a working group led by Pierre Werner, Luxembourg's prime minister and finance minister. Although all the member states agreed on the goal of monetary union, how to achieve that goal proved to be a matter of substantial contention. The members of the committee divided into two camps, known colloquially as "monetarists" and "economists." The "monetarists," which included the French, Belgians, and Luxembourgers, argued for an immediate move to fixed exchange rates, which would, in turn, prompt the convergence of member states' economic and monetary policies. The "economists," who included the German, Dutch, and Italian governments, believed that the convergence of economic and monetary policies should precede the move to fixed exchange rates (Kruse 1980, 58–62). The German government feared that the move to fixed exchange rates before policy convergence would lead to imported inflation for Germany, in that the Bundesbank would have to support weak-currency countries as they came under depreciating pressures. The French government felt that the German position signaled an unwillingness to carry some of the burdens of integration. The divergent positions could not be reconciled, and when the Werner Report was issued in 1970, it left the details of EMU (optimistically planned for completion by 1980) to further negotiation.

A central reason for the push toward EMU was the condition of international monetary institutions. The Bretton Woods monetary regime was facing profound challenges by the late 1960s. The integration of financial markets, which resulted in greater capital mobility, and the changing interests of major actors within the regime were factors which led to stresses within the regime for which it was inadequately designed to withstand (Gomes 1993, 263). These factors made it increasingly difficult for the United States to maintain its own balance-of-payments and its domestic economic policy goals. The decision of the U.S. government in 1971 to close the gold window and thus effectively end the Bretton Woods regime was in reaction to the perceived burden that further maintenance of the regime placed on the domestic policies of the United States (Gowa 1983).

The semicollapse of the Bretton Woods regime in August 1971 posed a serious threat to the EMU plan. A float of European currencies would have essentially killed the EMU plan (which called for a prolonged period of exchange rate stability) and would have threatened the viability of the CAP. The Smithsonian Agreement of 1971, the multilateral agreement which widened the exchange

rate bands of currencies pegged to the dollar, meant that EC currencies could actually diverge as much as 9 percent from each other (Goodman 1992, 186). This was seen as too great a threat to the CAP, and a compromise was worked out which allowed for narrower EC exchange rates.

The system that resulted in March 1972 was known as the "Snake in the tunnel," for it allowed for a +/− 4.5 percent fluctuation of EC currencies against the dollar, but only for a +/− 2.25 percent fluctuation of any two EC currencies against each other.[3] The tunnel aspect of the system lasted until March 1973, when the "Snake" members stopped pegging their currencies to the dollar and engaged in a joint float.

The "Snake" was an inherently asymmetric exchange rate regime. In the "Snake," each country's currency was fixed within a band of +/− 2.25 percent around a central rate with each of the other member countries' currency. This meant member governments and central banks had to keep their currencies within the bands by maintaining similar monetary policies or through currency market interventions when their currencies came under market pressures. In reality, the "Snake" functioned as a deutsche mark zone because the deutsche mark was the most stable and highly valued currency in the regime. As the deutsche mark consistently appreciated, the other member states of the system with weak currencies had to adjust their monetary policies to maintain their currencies within their bands with the deutsche mark. The Bundesbank maintained a very tight monetary policy in comparison to other West European states, meaning that weak-currency countries saw themselves forced to severely tighten their monetary policies in order to keep the markets from attacking their currencies. The Bundesbank could, for all intents and purposes, maintain its monetary policy as if the "Snake" did not exist. Thus the asymmetry of the regime came from the fact that the weak-currency countries shouldered the burden of intervention, while the hard-currency Germans could follow their own domestic imperatives.

The oil crisis of 1973 led Britain, Ireland, and Italy to abandon the "Snake" even before it left the tunnel; France left the system in January 1974. The "Snake" shrank so drastically in such a short time due primarily to the lack of willingness on the part of the weak-currency countries to abandon their domestic economic goals and follow the Bundesbank's tight monetary policies in the wake of the inflationary shock of the oil crisis.[4]

The European Monetary System Initiative

The failure of the "Snake" arrangement provoked deep pessimism among the EC's political elites about the future of European integration. Since the ma-

jority of the EC's member states floated their currencies against each other, the CAP was seriously threatened with collapse, as the process of calculating price supports for farmers became increasingly difficult. By the late 1970s, the integration process seemed dead in its tracks.

Fearful of the consequences of the Community's stagnation, the president of the European Commission, Roy Jenkins, felt a drastic step was needed not only to get the integration process started again but to save the Community from possible disintegration. Jenkins looked to the monetary realm to restart the integration process, despite the recent failure of the EMU plan and the "Snake." In a series of speeches in 1977, Jenkins proposed a new set of European Community monetary institutions fashioned into a European Monetary System which would provide a zone of monetary stability for Europe and set the stage for an eventual move toward monetary union (Ludlow 1982, 55).

Jenkins's proposal met with a general lack of enthusiasm. The German reaction was very cool. The finance minister, Hans Apel, argued that the system would most likely be inflationary. Chancellor Helmut Schmidt was also reluctant at first, although his reluctance seemed to stem more from doubts about the political feasibility of the venture than from its possible negative effects on the German domestic economy. However, Schmidt came around to the idea of the EMS in the months following Jenkins's speeches. By February of 1978, Schmidt had taken on the EMS idea as his own personal mission and quickly converted Giscard to the cause. Together, these two would be the principal champions of the EMS cause.

The reasons for Schmidt's conversion seem to lie in a variety of considerations. He, like Brandt before him, came to believe that the disruptive effects of monetary instability on the CAP threatened to pull the EC apart or at least stall the integration process, which would have seriously damaged French-German ties (see Giavazzi and Giovannini 1989, 12–19). Schmidt also began to see exchange rate instability as threatening to intra-European trade, which had increased greatly since the creation of the EC. For Schmidt, the EC began to take on an increased importance, as the United States showed increasing signs under the Carter administration of relinquishing its international leadership position (Carr 1985; Strange 1980; Story 1988).[5] Schmidt summed up his position on what the EMS was meant to accomplish this way: "I see it as an instrument to let the countries of the EEC grow together more quickly than hitherto. I see it as an instrument also to strengthen the EEC institutionally, and I see it as an incentive for the Americans to understand that they must not let the dollar go down the drain" (Hanrieder 1982, 209).

Schmidt intended for the EMS to be a much more symmetric regime than the "Snake": "I'm not so much thinking of enlarging the 'Snake,' but of something

that goes a little beyond the present 'Snake.' I am thinking in terms of pooling currency reserves. I'm thinking about a European unit of account that would also be the medium in which you settle accounts between the European central banks."[6] Here Schmidt seems to be pointing to the symmetry he intended for the new EMS. His primary reason for wanting the EMS to be a symmetric monetary regime was the experience with the "Snake." The asymmetry of that arrangement had proven unbearable to weak-currency countries and had led to the collapse of the regime's general effectiveness. Creating another asymmetric regime would not further Schmidt's cause of trying to deepen the integration process to consolidate Europe's power vis-à-vis the United States. Another asymmetric regime would only set the stage for further tensions between Germany and its weak-currency neighbors. Moreover, he was quite aware from his conversations with Giscard that the French would not be willing to accept a "Snake" by another name.

But there was a risky domestic political aspect to creating a symmetric regime to replace the "Snake." A symmetric EMS would force the German Bundesbank to be more expansionary than if it were completely free from exchange market intervention burdens. In other words, the EMS could force the Bundesbank to do what no postwar German chancellor had been able to, loosen its monetary policy.[7] Schmidt knew he would face opposition from the Bundesbank and other organizations in Germany in his endeavor to create the EMS, but he seemed perfectly willing to make the sacrifice of increased German monetary expansion in order to realize this project. In the same interview cited above, Schmidt indicated the possible sacrifices that the EMS would mean for both weak-currency countries and Germany:

> Of course there are also some risks. If somebody ties his national currency to such a complex, he comes under stricter rules as regards his overall economic behavior. In a way, you have to gear your fiscal and monetary behavior so that you can maintain your exchange rates without sacrificing your currency reserves or drawing too heavily on some joint pool or on monetary assistance from your partners. It might mean for Germany, on the other hand, that we have to sacrifice some of our reserves. It might also mean that we have to expand our money supply somewhat more rapidly than we have done until now.[8]

Schmidt had little difficulty convincing Giscard of the need for a strengthened EC in the face of U.S. weakness, inasmuch as that had been a consistent French position. Giscard also wanted to use the EMS to bring stability to European exchange rates, which would facilitate EC trade. He also wanted to use the exchange rate regime to impose discipline on the French economy in order to

decrease inflation. Perhaps most importantly, the French government had the most to gain from the EMS's effects on the CAP because of its large and politically powerful agricultural sector (De Cecco 1989, 89–90). Thus Giscard joined Schmidt to convince the rest of the EC's political elites of the regime's worth, a goal that was achieved, save for the United Kingdom.

Schmidt and Giscard presented the general outlines of a proposal for the EMS at the European Council meeting in Copenhagen on April 7 and 8, 1978. The plan presented the following proposed institutional components:

1. The creation of a European Monetary Fund (EMF).
2. The partial pooling of official reserves, with each country contributing between 5 percent and 20 percent of its reserves.
3. Increased use of European currencies instead of the dollar in currency market interventions.
4. Expanded use of the EAU as a means of settlement between central banks.[9]

Schmidt and Giscard's initiative was met with general acceptance by other European leaders, but it met a great deal of criticism in Germany. This criticism was to play a prominent role in Schmidt's strategy in trying to realize a symmetric EMS.

The German EMS Debate

Schmidt's proposal met much more vocal opposition than support in Germany following the Copenhagen Council meeting. The EMS initiative found organizational backers in the SPD, which was Schmidt's own party, and the DBV, the farmers' organization, which supported the idea of fixing exchange rates and thus rescuing the CAP.[10] The DGB, the SPD's usual political ally, generally supported the idea of an exchange rate regime for the EC. A senior DGB functionary states: "We did not have the worries of the Bundesbank. We were more interested in the larger economic aspects and less in questions of monetary stability."[11]

Despite the DGB's general support for the EMS concept, the organization did not engage itself to politically support Schmidt's position vis-à-vis the organizations that opposed the idea. This lack of action on the part of the DGB was due to two factors. First, the DGB was not completely convinced of the feasibility of the plan. Second, it had never engaged itself politically on matters of EC monetary politics, generally leaving such matters to its "social partners," the industry organizations.

Fearful that the EMS would import inflation into the Federal Republic as had

the Bretton Woods regime, many organizations came out to voice their skepticism if not open hostility to the initiative. The Bundesbank was the most prominent critic of the plan. It argued that a system of fixed exchange rates threatened to import inflation into Germany from its inflation-prone neighbors. By linking the deutsche mark to the weak franc and lira, the Bundesbank believed it would have to face a greater threat from inflation and have fewer tools with which to combat it. The Bundesbank particularly feared the proposal to create a European Monetary Fund to which the Bundesbank would have to surrender a share of its reserves. The Bundesbank feared having to intervene in currency markets to support the weak European currencies, which would increase domestic German liquidity, thus threatening its own domestic stability goals.[12]

The Bundesbank was joined in its criticism by a large number of other organizations which feared the inflationary potential of the EMS proposal. The opposition CDU and CSU were quite vocal in their fears that the EMS would turn into an "inflation community," although they were careful not to criticize the spirit of EC monetary integration.[13] Even Schmidt's own Finance Ministry raised criticisms of the plan within government circles, although it was careful to keep the criticisms out of the public debate.[14]

The leadership of the Federation of German Industry (BDI) and the German Chamber of Commerce (DIHT) were also critical of the plan. These organizations shared the fears of the Bundesbank that a set of international monetary institutions, which could constrain the Bundesbank's ability to control the domestic German monetary supply, would bring inflation into Germany. As a BDI functionary points out: "We were very skeptical, like the Bundesbank. We feared it could lead to inflation and put the Bundesbank under pressure."[15]

These organizations felt that inflation was a greater enemy than were the disadvantages that exchange rate instability posed to Germany's external trade.[16] The BDI issued this formal statement concerning the planned EMS:

> Every endeavor to advance the integration of Europe is to be welcomed. The objective behind the system also deserves support from the point of view of monetary policy. In practice, however, the autonomy of national central banks—particularly those of hard currency countries—will, if not formally then in fact, be impaired. Through intervention obligations they lose the scope of action that in the past enabled them to conduct a policy at the national level designed to ensure price stability. However, price stability must enjoy absolute priority in all the EMS member countries. Ultimately, it is only on this basis that a zone of monetary stability in Europe can be established.[17]

But the BDI's membership was not uniformly opposed to the idea of a fixed exchange rate regime for the EC. Firms with large portions of their business involved in exporting had an interest in stable exchange rates, but they made it clear that they would not trade stable exchange rates for domestic price stability. In order to get their support, Schmidt would have to assure them that he would not sell out the Bundesbank for purposes of European monetary integration. This left the leadership of the industry organizations and the smaller firms severely weakened in their hopes of blocking the venture.

Banking organizations were also divided. The leadership of the Federation of German Banks (BDB), the most powerful German banking association, was critical of the plan inasmuch as it feared its inflationary potential.[18] But several powerful banks, such as Commerzbank, Dresdner, and Deutsche Bank, within the BDB were willing to hear out Schmidt. Their reasons for not rejecting the plan outright were their ties to the large exporting firms. Because the big three banks had such close financial relations with the large German exporting firms, their interests in the EMS were largely congruent. The German Savings Banks Federation (DSGV) as well as other banking organizations with no international trade ties loudly opposed the plan for fear of its domestic inflationary potential.[19] But the interest of the largest banks blunted the opposition of the BDB and also weakened the hand of other financial organizations that opposed the monetary regime project.

Despite widespread criticism of Schmidt's proposal by many organizations, this did not mean that the idea behind the EMS was dead. As the proposal was still merely a proposal and not a concrete plan, the Chancellory had some room to maneuver. It was clear that if Schmidt went too far too fast with the project it would be scuttled by domestic German opposition. To avoid that, he decided to proceed with planning the EMS in secret rather than bringing in the German Bundesbank and Finance Ministry. Schmidt was aware that they would try to kill the plan if they could.

Schmidt and Giscard devised a strategy to outflank the domestic German opposition. They first agreed that the EMS proposal should not be decided in formal EC bodies, namely, the Monetary Committee and the Committee of Central Bank Governors. They knew that if the proposal were to be decided there it would surely die at the hands of the Bundesbank. Thus Schmidt and Giscard began working on a general outline of a plan following the Copenhagen European Council meeting. Schmidt used his economic advisor from the Chancellory, Horst Schulmann, as his negotiator; Giscard used Bernard Clappier, a former governor of the Banque de France. These two parallel paths to plan design worked on the idea of the EMS through April and into May 1978. When the news leaked on May 26, 1978, that Schmidt and Giscard were

meeting in secret to negotiate the design of the EMS, the conflict over the EMS proposal began in earnest in Germany.[20]

The Formation of the Bundesbank's Policy Coalition

The Bundesbank's reaction to the news of secret negotiations was swift and decisive. The Central Bank Council of the Bundesbank decided that Schmidt needed to be constrained before he made any agreements with the French that would bind the Bundesbank to a monetary regime. The Bundesbank strategy consisted of two major parts: warnings to the government and coalescing with industry and banking organizations in order to constrain the Chancellory from making any agreements with the French that would threaten the Bundesbank's autonomy. The first step was taken in the form of a warning issued by Bundesbank President Emminger on May 26 to Schmidt not to enter into any binding agreements on the EMS at the Bremen European Council meeting scheduled for July 6, 1978.

The second step of the Bundesbank's strategy consisted of meetings in early June with the leaders of the BDB, the BDI, the DIHT, and other major interest organizations to discuss ways to prevent the creation of an EMS that would infringe upon the autonomy of the Bundesbank. The Bundesbank also met with Finance Ministry officials, to discuss a joint approach to the issue.[21] Thus by the beginning of June the Bundesbank had congealed a formidable policy coalition that aimed to shape German policy on the EMS project.

At this point, Schmidt was still hoping to achieve the creation of a symmetric EMS in order to strengthen German-French ties. But Schmidt was quite aware by late June that his original vision was in danger from the Bundesbank-led coalition that had formed.[22] He could no longer hope to continue the EMS design without taking into consideration the demands of this newly developed coalition. Thus on July 5, the day before the Bremen summit, Schmidt met with some twenty industry, banking, and labor leaders to discuss the EMS project.[23] The point that was made very clearly, time and again, was that Germany should not enter into any arrangement that would constrain the Bundesbank's control of domestic monetary policy.

Schmidt went to the Bremen summit clearly forewarned about making any deals that would bind the Bundesbank to any monetary regime it had not sanctioned. But Schmidt also faced the dilemma that he had to please Giscard, or the whole idea of the EMS would falter.[24] The result of the Bremen summit was a vaguely worded communiqué that expressed what the European Council intended for the development of the EMS. The most important part of the Bremen Communiqué was the annex, which detailed five points about the future

EMS. The central issues were that the European Currency Unit (ecu) would be at the center of the exchange rate regime and not later than two years after the start of the regime a European Monetary Fund would come into being. But the details of these two provisions were not given. They were to be left to negotiations that were slated to be completed by October 31, 1978.[25]

The results of the Bremen summit did little to lessen the fears of the Bundesbank coalition that Schmidt intended to create a symmetric EMS in order to placate the French government. The Bremen Communiqué, although vague, mentioned the ecu's being at the center of the system, and seemed to imply the creation of a symmetric regime based on a basket currency and not on bilateral exchange rates. This led several organizations and prominent politicians to state their concern about Schmidt's intentions.[26]

The Bundesbank decided following the Bremen summit that the possibility that a deal would be struck between Schmidt and Giscard was still great despite warnings from industry, banking, and even state organizations such as the Bundesbank. The misgivings of the Bundesbank and its informal coalition partners led the Bundesbank to adopt a new strategy to constrain Schmidt. The central bank and its allies decided that the only way to keep Schmidt from making a deal with Giscard was to engage in brinksmanship. In other words, the Bundesbank would state to Schmidt the absolute minimum conditions that would allow the central bank to cooperate with the creation of the monetary regime. If Schmidt rejected those conditions, then the Bundesbank would not cooperate in the operation of the EMS.

To this end Otmar Emminger, president of the Bundesbank, attended a cabinet meeting on July 12, 1978, to present the Bundesbank's views on the EMS's design.[27] Emminger's primary concern was that the EMS, with a basket currency at the center, would lead the Bundesbank to have to intervene frequently in currency markets, thus robbing the central bank of its control of the money supply which would lead to German inflation.[28] Emminger stated in the cabinet meeting that the Bundesbank was quite concerned about its role in shaping the institutions of the new EMS; according to Emminger, those rules would be the deciding factor in whether the Bundesbank would accept a participatory role in the planned monetary regime. The only way it could shape the rules of the EMS would be if it played a direct role in shaping the German position in upcoming institutional negotiations. Thus what Emminger was stipulating was that the Bundesbank would cooperate with Schmidt's plans only if the central bank were included in the process of designing the EMS.

Aware that the Bundesbank president had issued an ultimatum, Schmidt promised that the Bundesbank would become part of the negotiation process. His intention was to widen the scope of negotiations to include forums for

finance ministers and central bankers to give their input into the final design. The two forums would be the Committee of Central Bank Governors and the Monetary Committee, which included both central bankers and finance ministers. This meant that the Bundesbank and its ally, the Finance Ministry, now would play central roles in designing the EMS, as long as Schmidt would abide by their suggestions in the final stages of design.

The Bundesbank's brinksmanship strategy seemed to generate a major victory for it and its coalition partners. By agreeing that the Bundesbank be part of the design negotiations, Schmidt was apparently conceding defeat on the symmetry of the EMS, in that the German central bank would never accept the ecu as a basket currency at the center of the regime. But the Bundesbank's role did not assure the central bank would get its way in the end. What mattered most was what Schmidt agreed with Giscard in terms of the final details of the regime. The key variable was whether Schmidt would discount the potential backlash from ignoring the wishes of the formidable Bundesbank-led coalition. While not likely, it was a possibility.

The Bundesbank's Policy Coalition and the EMS Negotiations

The Committee of Central Bank Governors and the Monetary Committee met several times in July and August 1978 to hash out a detailed plan for the EMS. The plans developed by the committees would serve as suggestions for the heads of government, who were to meet in December 1978 in Brussels to finalize the EMS design.

Two sets of rules were the center of contention during the negotiations. The first set were the rules over the design of the Exchange Rate Mechanism (ERM), that is, how the system would react to divergent exchange rate movements and which central bank would have to intervene. The committees split from the outset into two camps: the minimalists and the maximalists. The minimalist camp, led by the Germans, wanted the ECU to play a very limited role in the EMS. In particular, the minimalists did not want the ECU to serve as basket currency, through which exchange rates would be fixed. The maximalists, led by the French, wanted the ECU to serve as the functioning center of the regime. The Bundesbank and the Finance Ministry rejected the French proposal that the ecu become the central means of calculating a currency's exchange value. The use of the ecu as the means of determining divergent exchange rates meant that there would be no bilateral cross rates. Therefore, one currency could reach its limits without the other currency necessarily reaching its limits at the same time. The French (as well as the Italians and British) liked this system, as it would have taken the burden off them somewhat since

the franc came under frequent depreciatory attacks and they would not be forced to follow the deutsche mark as with the parity grid. The Bundesbank and the Finance Ministry demanded instead that the parity grid system, as was used in the "Snake" regime, be the central means of indicating divergence. The Bundesbank and its allies feared that the use of the ecu would force the Bundesbank to intervene to support the weaker currencies. By the end of the negotiations in September, the German negotiators from the Finance Ministry and the Bundesbank were able to kill the maximalist proposal in the committees.

The second set of rules concerned the intervention financing facilities. The financing facilities also proved contentious, as they greatly determined the burden central banks would have to bear. Schmidt and Giscard had called for a European Monetary Fund (EMF), which would serve as the central long-term intervention financing fund for the EMS members. The Bundesbank opposed this fund for fear that it would be used as a trough for weak-currency countries to finance their interventions and would allow them to avoid picking disciplined monetary and economic policies, thus forcing the Bundesbank to pick up the burden of adjustment. The Bundesbank was able to get the idea of the EMF shelved until some undesignated point in the future and instead cautiously accepted the Very-Short-Term Financing Facility, the Short-Term Monetary Support, and the Medium-Term Financial Assistance provisions.[29]

The German negotiating team in the committees was able to get most of what the Bundesbank coalition wanted for the EMS. The plan that resulted from the negotiations was an inherently "asymmetric" regime. The crucial goal now for the Bundesbank policy coalition was to get Schmidt to accept the committee plans.

Schmidt was to meet Giscard in Aachen on September 14–15 to hash out a joint German-French position on the design. For the parties involved, the Aachen summit appeared to be the moment of truth. Schmidt and Giscard would either agree to shape the EMS as an asymmetric or symmetric exchange rate regime during the course of their otherwise routine German-French consultations. What was agreed upon at Aachen would indicate what the Brussels European Council would decide.

Schmidt had little choice but to consult with the Bundesbank and major interest organization leaders before meeting Giscard in Aachen. The Bundesbank policy coalition wanted assurances that he would not ignore their demands for an asymmetric EMS. Thus on September 13, Schmidt met with the Bundesbank Directorate and banking and industry organization leaders at his invitation. Schmidt's guests admonished the chancellor not to agree to French demands for a symmetric EMS.[30]

Schmidt went to Aachen warned about placating the French government. To add to the pressure, Karl-Otto Pöhl, vice-president of the Bundesbank, accompanied him to Aachen. Thus, Schmidt met Giscard knowing that he faced a major political battle at home if he agreed to the French president's preferred EMS design. This led Schmidt to essentially replicate the Bundesbank's policy coalition's position.[31]

Conclusion

This case of German policy change shows just how important two aspects of institutions are to politics: institutions' ability to shape distributional outcomes and their ability to constrain policy choices. Calculations of future gain from the EMS regime clearly mattered to the actors involved. Concerns about the future distributional consequences of the EMS in Germany were the primary motivations for both state and societal organizations' behavior in the debate over the initiation of the regime and the conflict over its design. While the distributional consequences of the EMS drove the motivations of the actors in Germany who hoped to shape policy toward the monetary regime, it was how domestic policy institutions shaped the conflict between the interested organizations that determined the dynamics of German policy. How institutions divide the responsibility for policy among state organizations and how they give societal actors a say in the policy process clearly mattered to how the German government decided on the rules of the EMS.

4 Challenging Bundesbank Dominance: The Franco-German Economic and Finance Council Initiative

The EMS settled into a pattern of relative exchange rate stability by the late 1980s, after a rather turbulent first several years. Part of the reason for this calming of exchange rate fluctuations within the EMS lay partially in the upswing in the international economy and the stabilization of the U.S. dollar. But most important for calming exchange rate fluctuations was EMS members' decisions, particularly France's, to accept their role as followers of the German Bundesbank's stability-oriented monetary policy.

Political change in Germany did not seem to have any effect on German policy toward the EMS. The SPD-FDP coalition collapsed in 1982 over disagreements concerning social and economic policy and was replaced by a CDU/CSU-FDP governing coalition. This change in government did nothing to alter Germany's position on European monetary integration.

But by 1987, the economic and political burden of following Bundesbank monetary policy had become acutely painful for states like France, which saw the real value of its currency plummet, its economy struggle to grow within a context of tight credit, and its trade deficit with Germany grow. The institutions of the EMS, to a large extent, defined the roles the members found themselves playing after 1979. France and other weak-currency states, such as Italy and Belgium, believed that the institutions of the EMS forced them to sacrifice important domestic political goals, while the Bundesbank could create policies while paying little heed to its fellow EMS members. Multilateral EC efforts to reform the institutions of the EMS, such as the Basel-Nyborg Agreement, made no significant change in the Bundesbank's dominant position in the EMS because the reform did not alter the institutions that made the strongest currency the anchor and put the burden of policy adjustment on weak-currency countries.

The French window of opportunity for constraining the Bundesbank came in the form of the Franco-German Economic and Finance Council, initiated in 1987. The council was proposed by the French government to improve

French-German monetary policy coordination and thus improve the functioning of the EMS. The idea was suggested by the French, who intended to use it to constrain the Bundesbank by putting the central bank into a collective decision-making framework where it could have exercised control over German monetary policy. The Kohl government initially agreed to the French proposal to coordinate economic and monetary policies with the French government through an Economic and Finance Council. But by March of 1988, the German government changed its position on the council and stripped the treaty of the institutional provisions that would have constrained the Bundesbank in any significant way.

Why did the German government strip the Franco-German Economic and Finance Council of any real significance when it had itself agreed to the original French council proposal? To answer this question we must ask how this proposed attempt at international institutional creation generated domestic political conflict within Germany and how that conflict then shaped German state actors' positions regarding the institutional changes in question.

The proposed institutional creation envisioned in the Franco-German Economic and Finance Council is a clear example of a battle over how an international institution can be used to affect the distribution of domestic policy-making power. The battle would center on whether the Bundesbank would surrender some of its monetary policy power to an international decision-making body consisting of the French and German governments. The German institutions of policy making would prove crucial to the outcome of the conflict by bringing banking and industry organizations into the fray, which allowed the Bundesbank to block the plan in its original form.

The International Consequences of Bundesbank Dominance

The EMS's debut was less than spectacular from the viewpoint of its initiators. It was meant to begin in January of 1979 but was postponed until March of that year because of a dispute over agricultural remuneration.[1] It became obvious in the first years of the EMS's existence that the planned changes in the regime would not be realized. The plan to use the ecu as the central intervention currency was based on the idea that ERM member central banks would come to use the ecu in interventions rather than their own national currencies. But the ERM central banks failed to pick up on the use of the ecu as the intervention currency for the regime because of several reasons. First, debtor central banks were reluctant to use the ecu because they would eventually have to get more ecus from other central banks in order to settle their accounts. Creditor central banks, on the other hand, were reluctant to use the ecu because of its lack of

credibility and the regulatory limits on its use (Ungerer et al. 1983, 16–17). Because of the failure of the ecu to develop into the central intervention currency, the system was anchored to the most stable currency and not the average of all currencies, as had been envisioned in the original EMS plan. The deutsche mark, being the most stable currency in the regime and having a track record of consistent appreciation, became the anchor currency as well as the main intervention currency. This development came despite the reservations of the Bundesbank that the use of the deutsche mark as a reserve currency threatened to import inflation into Germany.[2]

The credit facilities originally planned for the EMS failed to be realized. The European Council Resolution of December 5, 1978, called for the creation of a European Monetary Fund, modeled after the IMF. This fund, which was meant to provide the regime members with a source of funds to maintain the regime's exchange rate stability, was supposed to have been in place two years after the regime's inception. But the idea of the fund faded into the background as the EMS rapidly developed into a deutsche mark zone, and the Bundesbank made it clear to its fellow European central bankers that it would not accept the further development of the fund.

Although the French and Italian governments may have had their reasons for welcoming some of the austerity that German monetary dominance was to impose on them in the early 1980s, the Bundesbank's monetary discipline was becoming increasingly troubling by the late 1980s. The French and Italians found reason to challenge the fairness of the EMS because of the rules of intervention. Although the EMS was originally intended to be a symmetric regime, in reality it was always the central bank whose currency was least in demand which shouldered the burden of intervention (Granet 1989, 59). As the French and Italian currencies were almost always the currencies least in demand, the burden of adjustment fell disproportionately on their central banks.

The French and Italians were also beginning to lose patience with the perceived deflationary effect that the EMS was having on their economy. The French had to maintain even higher interest rates than the Germans throughout the 1980s in an attempt to maintain the value of the franc within its ERM bands of allowable fluctuation, which consistently faced downward pressure because of high German interest rates and the tendency for speculators to sell francs and buy the deutsche mark.[3] Unemployment rates rose alarmingly in the mid-1980s and were maintained at high levels throughout the decade.[4] Growth rates in France and Italy also followed the German pattern, with disappointing economic growth being the norm for the decade.[5]

Another source of irritation for the French and Italians was the manner in which the Bundesbank intervened both marginally and intramarginally to

prop up currencies which were slipping out of their bands in the ERM. The rules of the EMS demanded that a central bank intervene only when a currency had reached its central rate bands. But to wait to intervene until a currency had reached its floor would be both extremely risky and costly in terms of interventions. In practice, that meant that weak-currency central banks (the Banca d'Italia and the Banque de France) were forced to engage in frequent intramarginal interventions to maintain their currencies' values before they got to their floors. There was no obligation on the appreciating currency central bank, that is, the Bundesbank, to intervene intramarginally to help maintain the values of the weak currencies. The Bundesbank only had to intervene if the weak currencies hit their floors. What this meant was that the burden of intervention was carried not by the Bundesbank, the center of the regime, but by the weak-currency member central banks.

The pattern that emerged from the early and mid-1980s was that several of the EMS's initiators' goals were not being realized. Granted, the EMS did bring greater exchange rate stability to its members and there was a decrease in inflation within the member states. But the EMS also had developed into an asymmetric regime where the original institutional plans had not been realized and the burden of adjustment was almost entirely on the weak-currency countries. On top of the asymmetry of the regime, the regime seemed to hamper economic growth, intra-EMS trade, and investment. In other words, most of the original goals of the EMS had not been achieved and the EMS appeared to be costing some of the important actors both within Germany and in the other member states dearly in both economic and political terms by 1986–1987.

Making the EMS More Symmetric: The Basel-Nyborg Agreement

The uneven and contentious first few years of the EMS seemed to be settling into a pattern of exchange rate stability and relatively lower inflation for all of the participants in the ERM by 1986. The first four years (1979–1983) of the exchange rate regime had resulted in seven realignments of the central bilateral parities of currencies. In the following two years the exchange rate situation had stabilized somewhat and only two realignments had been deemed necessary.

Although the EMS was calming down by the mid-1980s, the issue of realigning central rates became increasingly contentious between the EMS's member governments. Of the eight realignments of EMS central parities between 1979 and 1985, the French franc had been devalued four times and revalued only once. The Italian lira had been devalued five times. The deutsche mark, on the other hand, had been revalued five times. While this may have seemed a boon

for French and Italian exporters, it was in fact perceived as politically embarrassing for the French and Italian governments, which had to watch their currencies lose value while the German currency consistently gained in value. A consequence of these devaluations was the rising costs of German imports, upon which French and Italian industry depended, but more importantly these devaluations wounded the national pride of the French and Italian governments. Each time their currencies were devalued vis-à-vis the deutsche mark, French and Italian politicians were under pressure from their domestic constituents to account for why their currencies were prone to being dumped at the currency exchanges while the deutsche mark had become the world's second most-held reserve currency behind the U.S. dollar.

Despite the fact that there was significant price stability convergence among EMS members by 1986, it was not long before the EMS once again came under pressure. As the pressures on the franc became unbearable in April 1986 due to speculation, the French government asked for a realignment of the franc within the ERM and the franc was devalued by 3 percent.

This realignment was viewed by the French government as a sign that the EMS, as it existed, although useful in stabilizing exchange rates and prompting a decrease in French inflation, had become too damaging to other French interests, such as economic growth, jobs, and French national prestige. French Socialist Jean-Pierre Chevènement put the French frustrations this way: "We cannot accept forever the fact that the EMS is nothing more than a thinly veiled deutsche mark zone."[6]

Further realignments were no longer a politically viable alternative for ERM members. The only politically acceptable solution to further tensions in the ERM, in the French government's view, was to alter the institutions of the EMS to accommodate the need for greater symmetry. The issue of restructuring the EMS's rules for intramarginal interventions had become a topic after the contentious 1986 realignment. Faced with a situation of having to persistently expend a vast amount of their own hard currency holdings in order to save the franc from falling outside of its ERM bands, the French government proposed that measures be researched which could lessen the burden of weak-currency countries.

In the summer of 1987, a committee of central bank presidents worked on a plan to deal with the problem of intramarginal interventions. The draft proposal stipulated that a very-short-term financing facility be arranged that would essentially lend hard currency to weak currency countries under advantageous conditions. The conditions were that the short-term loans then could be repaid in ecus, rather than hard currency, and would therefore lessen the burden that weak-currency countries had to carry when their currencies came

under depreciative pressures and the intervention was complete. What the institutional proposal meant in practical terms was that weak-currency countries would borrow deutsche marks from the Bundesbank through the medium of the very-short-term financing facility. By paying back the loans in ecu, the basket currency unit which the Bundesbank never used, the weak-currency countries were asking the Bundesbank to agree to contribute a larger portion of its hard currency reserves as well as a portion of its policy autonomy to preserve the value of the weak currencies.

The report of the central bank governors was made public in the summer of 1987. Despite the Bundesbank's reservations about the proposed institutional changes, the initiative was carried forward by the Committee of Central Bank Governors. At an informal meeting of EC central bank governors held at a larger meeting at the Bank of International Settlements in Basel on September 8, the EC central bank governors announced that they had reached agreement on the plan to make some minor reforms in the EMS, although no statement was made as to the content of the agreement.[7] The "informal" meeting of EC finance ministers at Nyborg, Denmark, was meant to politically finalize the agreement made at Basel and make an official announcement on what institutional changes were to be made.[8] The final agreement that was announced seemed to be a compromise and stated that there would be strong currency contributions to the European Monetary Cooperation Fund (a German stipulation), the payback period for loans from the fund would be extended from 2.5 to 3.5 months, and there would be an increase of the duty to accept the repayment in ecus from 50 percent to 100 percent (weak-currency country stipulations).[9] The agreement that came out of the Nyborg meeting was unanimously accepted by all eight EC finance ministers whose currencies were part of the ERM.[10]

Despite the apparent unanimity of the finance ministers in agreeing that the reforms would improve the functioning of the EMS, a political battle over the interpretation of the agreement ensued immediately following the Nyborg agreement's announcement. The French position was that the institutional changes represented a step toward the second phase of the EMS, wherein the ecu was to become the anchor currency of the monetary system, as had been foreseen in the original EMS agreement.[11]

Fearful that its autonomy appeared threatened, particularly in light of the comments made by Delors and the French delegation, the Bundesbank quickly issued a statement intended to ease German industry and banking organizations' fears of a French takeover of German monetary policy.[12] Bundesbank President Pöhl stated unequivocally: "Central banks are in no way obligated to make increased interventions. In the present agreement we see no danger for

German stability policy, because there are specific conditions attached to the short-term financing agreements."[13]

The German finance minister, Gerhard Stoltenberg (CDU), agreed with the Bundesbank position and stated that there was no reason to fear the undermining of Bundesbank autonomy. Both the Bundesbank and Finance Ministry stressed that in no way did the agreement stipulate that the Bundesbank was automatically obligated to intervene intramarginally, despite the French delegation's statements to the contrary.[14]

The furor in Germany over the Basel-Nyborg Agreement quickly died down as its effect on the Bundesbank's position in the EMS and in the German domestic political economy proved insignificant. But French frustration with the Bundesbank grew. Although the French had blocked the path to further realignments in the ERM, they had not been able to dismantle the Bundesbank's dominance. The German central bank and its domestic supporters had once again shown their unwillingness to accept an institutional innovation that would develop the EMS in a more symmetric fashion. But it would be the German government that would present the next opportunity to challenge Bundesbank dominance in the EMS.

Undoing Dominance: The Franco-German Economic and Finance Council Initiative

As a gesture of goodwill toward the French, the German government proposed a series of amendments to the 1963 Treaty of Franco-German Friendship (known as the Elysée Treaty). The amendments were intended to strengthen ties in security by creating a joint security council. The idea of adding the security council to the 1963 treaty was proposed by Chancellor Helmut Kohl as a sign of friendship with the French in commemoration of the twenty-fifth anniversary of the Franco-German Friendship Treaty.[15] The French government pressed Kohl for a council for coordinating French and German economic and monetary policies. The proposed council was intended by the French government to give it some say over the course of German monetary policy, thus decreasing German monetary dominance of France. Kohl did not consult with the Bundesbank before accepting the council idea. In fact, the German central bank learned of the council plan from the German press.[16]

A draft treaty was worked out by French and German negotiators in the fall of 1987. The German negotiators (the Bundesbank was excluded from the negotiations) seemed to go a long way toward placating the French. The most important of those demands was that the treaty not merely be an intergovernmental agreement, as the Germans had originally intended, but that it have the

power of international law. But as a binding international treaty, the council protocol would have to be ratified by both countries' parliaments.

What was seen as a political gesture on the part of the German government was viewed as a window of opportunity on the part of the French government to finally end Bundesbank dominance by giving the French the chance to influence Bundesbank policy. The French hoped that the council would be a way to directly influence German monetary policy by tying the Bundesbank to the decisions of the council.

The draft treaty reflected the French hopes and the German government's attempts to secure a cooperative venue with the French government. The treaty committed the French and German governments to coordinate and harmonize their economic policies and international and financial and economic positions as much as possible. The council was to meet four times each year, alternately in France and Germany. It was to comprise the French and German finance and economics ministers as well as the presidents of the Banque de France and the Bundesbank. Article 4 of the protocol on the Economic and Finance Council set out the duties of the council:

> To consider the national budgets before they were to be passed each year by the governments and parliaments.
>
> To consider regularly the economic conditions and economic policies of each country with the goal of the greatest possible agreement.
>
> To consider the monetary policies of both countries in national, European, and international realms with the goal of the greatest possible agreement.
>
> To achieve the greatest possible agreement on the positions of both countries concerning international negotiations over economic questions.[17]

The treaty made no mention of differences in French and German domestic political institutions and how they would be reconciled with the treaty's stipulations. Most importantly, the treaty made no mention of the Bundesbank's independent status vis-à-vis the German government. Whereas the Bundesbank was legally autonomous from the German government, the Banque de France was attached to the French Ministry of Finance. Thus it made sense to assume that the French side of the council would act as a single body; but the same could not be assumed of the German side. By stipulating that the council would create binding decisions for both countries, the treaty implicitly nullified the Bundesbank Law of 1957 that defined the German central bank's autonomous status. Therefore the treaty would substantially alter the institutional framework of the German domestic political economy without

calling for any explicit changes in domestic German institutions.[18] In essence, the treaty contained within it the French hope of tying the Bundesbank to a decision-making body that would allow the French government to exercise control over German monetary policy, finally ending its aggravation with Bundesbank dominance of its own economic and monetary policies.

The German Ratification Conflict

The draft treaty was not made public until just before the signing of the treaty on January 22, 1988.[19] On January 21, Martin Bangemann, the German minister of economics, went to the Bundesbank to present the draft treaty to the Central Bank Council. Bangemann told the CBC members, much to their dismay, that the treaty would commit the Bundesbank by international law to coordinate its monetary policy with the French government.

The Bundesbank reaction to the draft treaty was swift and serious. It publicly criticized the council treaty because it did not say explicitly what the goals of council were to be. The central bank also attacked the draft treaty because it made no mention of the independence of the Bundesbank although it committed it to cooperate in the body. The Bundesbank called upon its legal counsel to begin proceedings against the German government over what the bank believed to be a clear breach of German law. The Bundesbank lawyers wanted a preamble to be inserted into the treaty that would clearly state that the Bundesbank would not be bound in any way by the decisions of the council. The bank also announced that it would only participate conditionally in the council if its concerns over the institutional question of its autonomy were redressed. The Bundesbank's lawyers fully intended to take their case to the German Constitutional Court if need be to defend the legal status of the central bank. On January 30, 1988, the bank's lawyers leaked their position to the German press, which then widely publicized the Bundesbank's fears.

German interest organizations and political leaders quickly took positions on the council plan. The opposition Social Democrats charged that the plan undermined the position of the Bundesbank. The SPD argued that the council would elevate the decision-making process to an unaccountable level. The SPD, never very stalwart for Bundesbank autonomy, was motivated by the opportunity the controversy generated for discrediting the governing CDU/CSU-FDP coalition.

The BDI was the most vocal and active critic of the plan, taking immediate steps to consult with the Bundesbank over a possible joint strategy to block the ratification of the treaty as it had been signed in Paris. The BDI circulated the

following internal memo in preparation for meeting with the leadership of the Bundesbank to work out a joint strategy:

> A great danger exists that the newly created Finance and Economic Council could possibly have the authority to hand the Central Bank Council orders and could encroach on its decision-making powers. We cannot expect that France will not resist from trying to hollow out the autonomy of the Bundesbank in little steps, with the final goal of creating a single European central bank. This has been the declared goal of Balladur (Finance Minister), Chirac (Prime Minister), and de Larosière (Central Bank Governor). . . . More exchange rate stability, one of the prime concerns of the newly founded Finance and Economic Council, can only result from a concurrence of political, social, and economic factors. This has precedence over the new harmonization bodies and mechanisms, which are thoroughly opaque. No protocol to the Elysée Treaty is going to make a hard currency country out of France.[20]

The Bundesbank was also supported by the DIHT, which viewed the council idea as superfluous since it believed that Franco-German monetary and economic cooperation was already strong enough. Foremost, the DIHT feared the danger the new set of institutions posed to the autonomy of the Bundesbank.[21] The DIHT, like the BDI, consulted with the Bundesbank to devise a plan of action to change the treaty. Banking organizations were also alarmed by the text of the treaty. The consensus among the BDB, the DSGV, the BVR, and the GSDS was that the treaty presented a serious threat to the integrity of the German central bank and that the council treaty should be amended before it could be ratified by the German parliament. The BDB, in particular, met with the Bundesbank leadership to exchange ideas about possible courses of action to influence the ratification process.

In the face of this very powerful array of organizations opposed to the treaty as it was published on January 22, the Kohl government struggled to calm fears and rebut criticism. Chancellor Kohl, Finance Minister Stoltenberg (CDU), and Economics Minister Bangemann (FDP) argued that the fears of the Bundesbank were not justified. They claimed that the formulation of the treaty protocol expressly considered the stipulations of the Bundesbank Law; the autonomy of the Bundesbank would not be damaged by the treaty in any way.[22] These officials argued that the treaty did not bind the Bundesbank's monetary policy and that the new institutions were meant to facilitate the exchange of information.

The government position found little active support from other organiza-

tions in the German political economy, although the DGB was generally supportive of the plan inasmuch as it disliked the Bundesbank's ability to dominate not only German economic policy but also the policies of Germany's European partners.[23] The council plan was welcomed by the DBV farmers' organization, but it, like the DGB, did nothing to actively support the initiative.[24] In both cases, these organizations did not believe that the council would directly impact their interests. Although Bundesbank dominance in the EMS may have presented some negative side effects for both organizations, neither organization saw the council as worth fighting for since its value to them versus the political costs of vying against the Bundesbank, the BDI, and the BDB was not readily apparent. Having secured the support of several of the most powerful organizations within Germany, the Bundesbank was in an advantageous position to take on the Kohl government. Seeing that the Bundesbank coalition was solidly committed to fighting the ratification of the council treaty in the German parliament, Kohl and his ministers made a quick effort to defuse the situation. Speaking in the Bundestag on February 4, Helmut Kohl promised that the council would not infringe on the autonomy of the Bundesbank and he promised to take measures to ensure that position would be formally stated in the treaty.

End Game

Although the government had conceded that the Bundesbank's fear of the council's impinging upon its autonomy were justified and needed redress, the question of how to deal with the treaty while pleasing both the French government and the Bundesbank and its allies remained. The options available to the government included inserting a preamble to the treaty or amending the text itself. Neither option appeared without political costs for the Kohl government.

The German Foreign Office wanted to insert a preamble into the protocol as it feared changing the text itself would anger the French and do serious damage to Franco-German relations.[25] One German diplomat said: "If we agree to that then the Economic and Finance Council is dead."[26] This view was based on a letter sent by French Finance Minister Bérégovoy to his German counterpart, Gerhard Stoltenberg, that protested the German plan to alter the treaty signed in January in order to deal with the Bundesbank autonomy problem.

The idea of the preamble to the treaty was opposed by a growing array of organizations. The Bundesbank argued that the preamble was not enough to guarantee that the council would not infringe upon the central bank's autonomy. The Bundesbank met with various ministries in Bonn to get them to

support its position. It was able to elicit the support of the Ministry of Justice and then the Finance Ministry, which changed its original position and came to argue that the preamble did not go far enough to protect the legal status of the Bundesbank in the German political economy.[27]

In the middle of this political battle was Helmut Kohl, who personally sided with the Foreign Office, but would have to take the political costs of making the final decision as to which course to take. Kohl stalled the decision in the hope of finding a way out. He blamed the delay on the French elections of the time, which he argued kept the French from being in a position to negotiate.

While the Chancellory languished over what to do about the treaty, the Bundesbank and its allies the BDI and BDB met with key members of the Bundestag and ministries to increase the pressure for a change in the treaty's text. These organizations applied direct pressure to the "economics" and "finance" working committees of the CDU and FDP parliamentary factions in order to sway them in favor of the Bundesbank position. By late March, these working groups took the position that a text change was necessary to guarantee the autonomy of the Bundesbank and that the council should only function as a consultative and not a decision-making body. This support from CDU and FDP parliamentary groups effectively isolated the Foreign Office as the only open supporter of the preamble idea.[28]

All the while the ratification conflict raged in Germany, the Bundesbank was actually taking part in meetings of the council. The first meeting, which took place in Bonn in March 1988, consisted of discussions of EMS financing and ended with no major results.[29] The second meeting, which took place in June in Paris, saw a considerable debate between the French and German sides over EC capital liberalization, which the French opposed.[30] The third meeting took place in the Bundesbank building in Frankfurt in September 1988, and served as a forum for the German central bank to demonstrate that it intended to participate in the council but had no intention of being bound by it. At the close of the meeting, the German finance minister announced that the council's agreements were only binding for the two governments; the Bundesbank's policy was to be made by the CBC, without recourse to the council.[31]

By September of 1988, the Chancellory's back was to the wall. Kohl had promised the French government that the treaty would be ratified by the end of 1988, but had not yet introduced the treaty to the Bundestag for ratification proceedings. Seeing that the coalition the Bundesbank had amassed against the preamble idea was much greater than the support Kohl and Genscher could muster, it was obvious that the government would have to give in. Kohl was able to gain the French government's agreement to a text change in the treaty protocol, as they also saw that it would not be ratified without it.

Having secured French approval, the German government introduced the ratification legislation in October 1988. The final version of the legislation detailed that the council was not a decision-making organ but a consultative body. The legislation also made clear that the autonomous status of the Bundesbank would not be affected by the council. The government was able to get the treaty protocol ratified by November with little trouble.[32]

Conclusion

The political battle that the Franco-German Economic and Finance Council unleashed in the Federal Republic is instructive for several reasons. This case of domestic conflict occasioned by international institutional change was clearly precipitated by the expected distributional consequences of those institutions. The supporters of the original council institutions, the German Chancellory and Foreign Office, stood to gain foreign policy leverage from the French. These organizations also stood to possibly gain electorally from furthering European integration. On the other side of the conflict, those who opposed the original council protocol stood to lose substantially from the constraints imposed by the new set of institutions. The Bundesbank faced losing its policy-making autonomy and its control over German monetary stability. This situation in turn threatened the interests of German banks and industrial firms, which depend on monetary stability for their economic success. Thus the way and magnitude in which the council institutions were expected to benefit or cost both state and nonstate organizations determined not only which side of the issue they took, but how actively they fought to achieve their goals.

The German government's turnaround on its position toward the council signified the limits of its power to engage in EC institutional creation that did not enjoy the broad support of both state and nonstate organizations within Germany. To have focused only on the interests and behavior of the German government would have failed to reveal the causes for its changing behavior over time. The institutional structure of policy making gave the Bundesbank a say in the council design as well. But policy-making institutions also gave societal institutions a role to play in shaping policy. Industry and banking organizations were pivotal in helping the Bundesbank force the Kohl government to back away from its initial conception of the council. Thus distributional concerns were behind the motivations for trying to shape policy, but it was the institutions of policy making which stipulated which organizations could actually exercise influence over the shape of policy.

5 The Ties That Bind: German Policy Toward European Monetary Union

The Maastricht Treaty on European Union represented the most ambitious plan envisioned by the European Community since the founding of that organization in 1957. The treaty outlined a blueprint for the creation of a set of European Community monetary institutions that would bind the member states in an economic and monetary union crowned by a European Central Bank. In other words, the institutions envisioned in the Maastricht Treaty would effectively strip the member states of most of their economic and monetary policy independence.

The Federal Republic of Germany stood at center stage during the process of creating the monetary aspects of the Maastricht Treaty. Unable to dismantle Germany's dominance of Europe's monetary politics through the Franco-German Economic and Finance Council or EMS reforms, the French government decided to push for an EC monetary union that would finally end German monetary dominance in Europe. But in order to realize the goal of a European Monetary Union (EMU), the French would have to get German policy makers to agree to the conditions whereby they would abandon their monetary autonomy and accept a single currency and European Central Bank (ECB). When the French government proposed EMU in 1988, the German Chancellory voiced skepticism and argued that monetary union should be a long-term goal. But in the fall of 1989, the Kohl government became a firm supporter of the EMU initiative and committed Germany to the EMU design process. When the plan for EMU was negotiated throughout 1991, the German government took a hard-line stance, calling for many criteria to be fulfilled. But when the German government negotiated the final treaty plan at Maastricht in December 1991, it agreed to several provisions that completely contradicted its earlier stance on monetary union.

The German relationship to the EMU initiative raises several questions. Why would the German government, which had stripped the Franco-German Economic and Finance Council of its significance, a much less profound measure of European monetary institutional change, and had expressed lukewarm sup-

port for the EMU idea from the onset, suddenly become one of the major advocates of the initiative by 1990? Furthermore, why did the German government then change from a hard-line position on the terms of the EMU design during the Inter-governmental Conference (IGC) to a position that in many ways contradicted the logic of its earlier position? What caused the German government to change its position on European Monetary Union in such a radical manner?

The reason for the discontinuity in German policy toward EMU lies in the way the monetary union stood to help some Germans and hurt others. Because those to be helped and hurt by EMU all had a say in the policy-making process at some point, they created a rather disjoint policy. When EMU was first proposed in 1988, a large and sufficiently strong coalition of the Bundesbank, the Ministry of Finance, and banking and industry organizations believed that the expected costs of a monetary union outweighed the expected gains to an extent that they pressured the Chancellory to remain aloof to the proposal. But changes in the international environment crucially altered the German EMU game. When German unification arose as a serious possibility, the German government changed its position and agreed to push for EMU in exchange for French acquiescence to rapid unification. This change came about because German state organizations such as the Chancellory, Foreign Office, Finance Ministry, and Economics Ministry perceived the electoral and diplomatic gains to be made from speedy German unification to outweigh the potential costs of EMU. These state organizations were able to draw key German industrial and banking groups into a loose coalition that then supported the EMU initiative based on the economic gains they expected from rapid unification. After the government accepted the initiative to start designing EMU, the German position was characterized by change caused by several state actors having a say in international monetary regime policy. This discontinuity in policy toward EMU has persisted.

The EMU Initiative and German Organizational Interests

European Monetary Union was first proposed in 1969 and resulted in the Werner Plan of 1970, named for the committee chaired by Pierre Werner, Luxembourg's prime minister. In both 1969 and 1988, European monetary union had both an economic and a political logic. In terms of its economic logic, EMU was considered beneficial for intra-EC trade as it would reduce the transaction costs inherent in using multiple currencies in trade. Also, EMU would facilitate economic efficiency in the Common Market by forcing the coordination of economic and monetary policies of EC members. Politically, a common

currency and central bank would bind the member states of the EC together so as to pave the way to eventual political union. This closely knit European Community would have the advantage of being a greater political and economic counterweight to the United States. A more closely bound EC also had the distinct advantage of tying the German economic giant down to Western European cooperation.

There were two schools of thought on the best way to achieve EMU. The "economists" favored an EMU process that would see substantial convergence of the participating economies before the institutions of EMU would come into place. The "monetarists" favored putting the institutions of EMU into place first, which would then force the participating countries to achieve economic convergence. In the debates leading to the Werner Plan, the German and Dutch governments represented the "economist" stance, while the French, Belgians, and Italians were convinced by the "monetarist logic." In the end, the "economists" held the most sway and the Werner Plan was based primarily on their thinking. The Werner Plan called for a Community monetary union to be established by 1980, but because of a combination of international monetary and economic crises and the lack of commitment by EC governments, the plan was dead by 1974 (see Tsoukalis 1977).

When the French government "relaunched" the EMU initiative in January 1988, it was prompted by monetary union's capacity to overcome Germany's monetary dominance of Europe. The French had tired of living with having their monetary policies dictated by the Bundesbank because of their membership in the EMS. In an attempt to escape from this dominance, the French government had tried to constrain the Bundesbank through reforming the EMS and then through the Franco-German Economic and Finance Council. But these efforts were stymied by the power of the Bundesbank to arrange German domestic coalitions against any institutional changes that could possibly threaten its policy autonomy and the German stability-oriented monetary paradigm.

Thoroughly frustrated by the effects of Bundesbank monetary policy on the French economy and their inability to overcome Bundesbank dominance through changes in the EMS and Franco-German avenues of cooperation, French politicians argued by the summer of 1987 that the EMS could not continue to exist as a deutsche mark zone.[1] French Socialist Jean-Pierre Chevènement complained: "It was suicidal to put France into a monetary system that was dominated by the deutsche mark. . . . We have offered French industry on the altar of this currency."[2]

The French government took the initiative in January 1988 by calling for a European Monetary Union and an EC central bank that would create mone-

tary policy for the entire Community. The French government did little to hide the fact that the move toward EMU was meant to supplant the Bundesbank-dominated EMS, which Premier Jacques Chirac described as "neither egalitarian nor complete."[3]

What did German state and nonstate organizations expect to gain or lose from a European Monetary Union? Their interests in EMU were very varied. The Chancellory generally supported the concept as a way of deepening European integration, which Helmut Kohl strongly backed as a means of legitimizing Germany's position of economic strength in Europe.[4] But any German chancellor who would agree to the idea of EMU would have to face the sure battle that would ensue in Germany over giving up the Bundesbank's autonomous role. Such a move could be achieved only from a position of political strength.

When the French broached the EMU initiative in January 1988, the Chancellory was facing a losing battle with the Bundesbank and its industry and banking organization allies over the plans to create the Franco-German Economic and Finance Council and it was not willing to come out to support an even more drastic step away from Bundesbank autonomy. These organizations made it clear to the Chancellory, both privately and through public positions, that they would not support a rapid move toward monetary union. Therefore Chancellory support for the plan would have been too costly domestically, as 1990 was an election year and Kohl perceived he could not afford the potential costs of taking on the Bundesbank over European integration. At the same time, outright rejection of the initiative would have soured German-French relations to an unacceptable degree. This led the German Chancellory to react with silence, waiting to see how the domestic German situation would develop.

The Foreign Office, and Foreign Minister Hans-Dietrich Genscher (FDP) in particular, had a strong interest in EMU as a way to improve relations with France, Germany's most important European partner. The Bundesbank's dominance of the EMS was viewed by Genscher as a substantial thorn in Franco-German relations; removing that thorn was crucial to convincing Germany's neighbors of its benign intentions. Genscher also viewed EMU as a way of convincing Germany's European neighbors of its commitment to its Western European ties in the light of the substantial changes occurring in Eastern Europe in 1989. Genscher, in his guise as FDP chairman, also reasoned that the FDP could capitalize domestically as being the party to do the most to support European integration, which was popular among German voters.[5]

Based on his calculation of the gain EMU would provide Germany diplomatically, and the boost it could provide the FDP, Genscher enthusiastically greeted the idea of a European central bank and EMU.[6] In a surprise move,

Genscher issued a formal memorandum in February of 1988 in which he stated his unequivocal support for the creation of EMU and outlined his vision of what it should look like.[7] In essence, Genscher argued that the European Central Bank should be built roughly on the model of the Bundesbank and be dedicated to its price stability ethos. Because the FDP also held the Economics Ministry portfolio, Economics Minister Martin Bangemann, the number two person in the FDP, came out in strong support of the Genscher memo.[8]

The Bundesbank's interest in avoiding a rapid move to EMU was clear. EMU would mean the end of the central bank's autonomy and possibly the German monetary paradigm. If French intentions were to use it to dismantle German monetary dominance in Europe, then they most likely intended to do away with the German central bank's stability ethos as well. The Bundesbank perceived the French calls for EMU as a direct attack on its policy autonomy, just as the Franco-German Economic and Finance Council had been intended.

The Bundesbank reaction to the French initiative and the Genscher memorandum was diplomatic yet cool.[9] Bundesbank President Karl Otto Pöhl stated he was not an opponent to the *idea* of EMU and that an EC central bank belonged to the logic of a single market for goods, capital, and services.[10] But Pöhl also pointed out that a majority of the German public was opposed to a single European currency and it would take a great deal of convincing before they would give up their beloved deutsche mark.[11] He also argued EMU was a distant goal that would be achievable only after EC member states' economic and monetary conditions had converged much nearer the German standard. EMU would be the crowning of a long and difficult economic and monetary convergence process.[12]

The Finance Ministry also had a strong interest in maintaining the Bundesbank's autonomy and the stability orientation of the German central bank.[13] It opposed the EMU idea if it meant anything other than the final step of a long convergence process. Thus the ministry came down squarely on the side of the Bundesbank. The Finance Ministry was particularly annoyed with Genscher for having spoken out for the EMU idea when it felt the issue was in its policy purview.[14] The Finance Minister, Gerhard Stoltenberg (CDU), issued his own memorandum, which like the Bundesbank position agreed with the idea of EMU but argued that it was a far-off goal that would require thorough political, economic, and monetary convergence.[15]

The opposition Social Democrats had an interest in forwarding EMU for two unrelated reasons. First, the EMU debate would allow the SPD to exploit the division in the German government over the issue. As Germany neared its general elections, discord within the governing coalition would be a godsend for the SPD. Second, the SPD was also genuinely convinced that Bundesbank

dominance of European monetary politics was deflating European economies (Germany's definitely included) and increasingly alienating the French. EMU would be a way to constrain the Bundesbank, an objective that was impossible in the context of German domestic politics. The SPD strategy consisted of criticizing the Finance Ministry's go-slow position on EMU while coming out to support Genscher's memo and the FDP position. The Social Democrats called for Germany to increase its cooperation with its EC partners in monetary matters with the goal of a rapid move toward EMU.[16]

Like its Social Democratic allies, the DGB (the Federation of German Unions) had an interest in forwarding EMU as a way of constraining the Bundesbank. The DGB had argued for some time that the Bundesbank's dominance of European monetary policies was retarding economic growth and keeping unemployment high. As one DGB functionary put it: "We are an export country and must pay attention to the economic situation here but also in the rest of Europe. The way the Bundesbank has set its monetary policies has hindered an upswing in other countries. A European monetary policy dominated by the Bundesbank does not work and leads to conflict."[17] The union federation hoped that a European Central Bank would be more committed to a broader conception of the relationship between monetary and economic policy.[18] The DGB was strategic in that it cloaked its hope of constraining the Bundesbank in the same manner of pro-EC rhetoric used by the SPD and FDP. This pro-EMU stance was notable for the DGB because it was the first time the German labor organization had come out to take a public position on an issue of European monetary integration.

The nonstate organization with the greatest interest in EMU was the German Farmers' Association (DBV). The DBV had a keen interest in realizing EMU because monetary union would end the problem of exchange rate fluctuations that periodically plagued the Common Agricultural Policy (CAP) payments system. A major reason for the creation of the EMS had been to deal with the problem of maintaining the CAP in the face of unstable exchange rates. A common EC currency would greatly facilitate the EC's agricultural subsidies program. The DBV called for EMU to be established as soon as possible in its official statements and in its meetings with government officials.[19]

Whereas German agriculture and labor perceived a clear interest in supporting EMU, German industrial firms and organizations had varied interests in monetary union. The idea found its greatest acceptance among some of the largest German firms, such as Daimler Benz and Bosch, which had substantial foreign sales and production and depended on stable exchange rates to lower transaction costs of their multinational production.[20] These larger firms took public stands in favor of EMU but did little else to push the project.

But most German firms, which did not have multinational production, were skeptical of the benefits.[21] In a survey conducted in October 1988, it was found that 60 percent of German industrialists supported the idea of a common European currency. This was by far the lowest percentage of acceptance of the EMU proposal among EC member states' industrialists.[22] German industrial firms' skepticism of the proposal was based foremost on the fear that a European currency would not be as strong or stable as the deutsche mark. As over four-fifths of German exports were denominated in deutsche marks, transaction costs for them were low. But the risks involved in giving up the deutsche mark's stability would be great for firms that depended on domestic price stability to keep them internationally competitive. In fact, 80 percent of German industrialists replied in the same survey as mentioned above that they did not expect a common EC currency to be as stable as the deutsche mark. Putting monetary policy in the hands of a European Central Bank was a great risk to those who were used to the Bundesbank paradigm (see Fröhlich 1992).

The most commonly heard comment from German industrialists about EMU was that price stability had priority over exchange rate stability. Both the DIHT and the BDI, which represented the majority views of their smaller members in their public positions, came out in favor of the general idea of EMU but expressed the belief that it was a goal for the long term.[23] As most German industrialists had little confidence that other European governments were ready to accept the Bundesbank stability paradigm, they publicly agreed with the Bundesbank and Finance Ministry that EMU was a distant goal. They also expressed their support for the Bundesbank position in their frequent meetings with central bank and Finance Ministry officials.

German banks and banking organizations, like industry, had varied interests in the EMU concept. The larger universal banks maintained an interest in monetary union because it would open the European market to competition. EMU would dismantle the barriers that other EC states had erected, which had kept the large German universal banks from dominating their markets. Deutsche Bank, Commerzbank, and Dresdner Bank thought that larger German banks stood to gain substantially from a common European currency because of their strength relative to their European competitors. The large German banks also were very closely tied to the larger German industrial firms, and therefore shared their interest in cutting transaction costs. Thus many of the top bankers expressed support for the EMU proposal when it was first announced. Alfred Herrenhausen, CEO of Deutsche Bank, took a leading role in advocating the initiative in the domestic German context.[24]

But the smaller German banks, like smaller German firms, were less assured that EMU would benefit them, as they believed price stability was their great-

est interest. As the smaller banks had less of a chance of dominating European markets and had few ties to multinationals, they would remain dependent on monetary stability to keep them competitive. They feared taking away the Bundesbank's monetary policy competence and giving it to an EC body. The division in opinion between large and small banks resulted in the Association of German Banks (BDB) taking a more conservative public stand than the large universal banks did themselves, as the majority of their members were the smaller banks.[25] The BDB also met with Bundesbank and Finance Ministry officials to discuss the EMU issue and make clear their position.

The German savings banks had no real interest in EMU, in that their primary priority had always been domestic price stability. They did not finance exporters or multinationals, but depended on price stability for their customers. All of these organizations clearly had an interest in forestalling the initiative since EMU, by taking monetary policy out of the hands of the Bundesbank, represented a serious threat to German monetary stability. It is not surprising then that they reacted with open skepticism to the EMU initiative. The Association of Savings Banks (DSGV), the Association of Cooperative Banks (BVR), and the Society for the Protection of the German Saver (GSDS) all stated that the time for EMU had not yet come.[26]

The Bundesbank, because of its informal coalition with the Finance Ministry and the banking and industry organizations, was aggressive in warning the Kohl government not to push for EMU before the Bundesbank and its allies thought the time was right. Bundesbank President Pöhl had this to say in the spring of 1988: "A European central bank and a European currency could be the crowning achievement of the long and difficult process to monetary union in Europe. The *Financial Times* was certainly right when it recently said: 'This is the time to defend the ground, not to shoot for the moon.' "[27]

As the Hannover EC summit in June 1988 approached, the German central bank was confident enough to claim that "the time was not yet ripe for an EC central bank" and there was little chance of such a bank coming about in the foreseeable future.[28] The Bundesbank and its coalition of EMU skeptics posed such a formidable political force in the run up to the Hannover summit that the Chancellory resisted taking a stance on the issue for fear of the domestic political backlash of supporting EMU in an election period and the conflict with France that would result if it rejected outright the EMU initiative.

Despite Kohl's noncommittal stance, the Hannover summit in June 1988 issued the call for the creation of a committee of central bankers headed by EC Commission President Jaques Delors to "study and propose concrete stages toward economic and monetary union" for the next summit to be held in Madrid the following year.[29] During the period between the Hannover sum-

mit and the release of the Delors Report in April of 1989, the EMU initiative was held in political limbo by the unwillingness of the German government to commit to the process as a short-term goal.[30]

When the Delors Committee released its report in April 1989, it was greeted by most within Germany as an acceptable outline for EMU.[31] Although the Delors Report primarily represented the Bundesbank's "economist" stance, it did not change the positions or strategies of any organizations toward the EMU question.[32] While the domestic German context remained unchanged after the disclosure of the Delors Report, the international pressure on Germany to commit to EMU grew more intense. French President Mitterrand pressed Kohl and Genscher to take concrete political steps to bring Europe closer to a plan.[33] At the Madrid summit in June 1989, France, Italy, Greece, and Spain pressured the German and British delegations to accept a move toward speedy EMU. Genscher and Kohl agreed to formally accept the Delors Report and the idea of an Intergovernmental Conference on EMU at some *unspecified* future date, but Kohl was unwilling to go any further because of domestic resistance led by the Finance Ministry and the Bundesbank.[34] With no change in the domestic German context, the EMU initiative remained dead in the water.

The Shadow of Unification and the Changed German EMU Game

The domestic German EMU game was fundamentally transformed on 9 November 1989, when the East German regime, in the face of mounting domestic political unrest, took the monumental step of opening its borders to the Federal Republic. Suddenly, the world faced the possibility of German unification with all its potential benefits and dangers. Foremost in the minds of Germany's European Community partners in November 1989 was the specter of a giant united Germany straying from its West European ties and taking up its traditional swing position between West and East Europe.

French President Mitterrand was quick to react to events in East Germany by putting pressure on Kohl, Genscher, and Finance Minister Theo Waigel to agree to a date for the Intergovernmental Conference (IGC) on EMU at the Strasbourg summit in December 1989.[35] The French government was successful in lining up Germany's usual "go-slow" allies, the Netherlands and Denmark, in favor of a rapid move toward EMU as a way of tying Germany to Western Europe, as they too feared an unconstrained united Germany.

Kohl's reaction to the French pressure was to reassure his domestic constituents by putting conditions on the German acceptance of a date for the IGC. Kohl argued that the EC needed a more thorough development of EC politi-

cal institutions such as the European Parliament before a drastic step like EMU could be realized.[36] The chancellor made every effort to convince those German organizations opposed to EMU that he would not trade away the German monetary paradigm to reassure the French about the German question.[37] He met in private with peak association officials and made public statements reiterating his caution toward EMU.

The week before the Strasbourg summit of December 9 and 10 changed the stakes for all German players. In a series of letters and phone calls, Mitterrand told Kohl that the German unification process would have to be "embedded in the perspective of the Community integration process."[38] In other words, the French president made French acquiescence to rapid German unification contingent on full German acceptance of the monetary union process.[39] France could exercise its power as one of the victors of World War II to get concessions from the German government toward European integration in order to tie the unified Germany to the European Community. France thus presented the German government with a stark choice: accept a rapid move toward EMU or accept a slow process of German unification.

Kohl now faced a very difficult political situation. He had the choice of trying to garner domestic support for Germany's agreement to the EMU design process or he could resist the French demands and possibly delay the unification process. To Kohl, the logic of moving to secure support for German agreement to the IGC was clear. German unification would be the single greatest political coup any German chancellor could hope to achieve. Kohl faced a general election in December 1990, and he suffered from a dangerously low level of public support in 1989. His approval rating had been on a downward trend since 1987, and was hovering around 45 percent (Anderson 1995, 79; Anderson, Kaltenthaler, and Luthdardt 1993). Kohl saw the unification issue as the most salient way to boost his political chances in the upcoming 1990 election. If he could at least establish an unobstructed path toward unification, he would substantially increase his political viability within the Federal Republic.[40]

But in order to commit the German government to the EMU design process, Kohl very much needed the support of German industry and banking. The SPD, the FDP, the DGB, and the DBV were already committed to the EMU concept. But if industrialists and bankers continued to support the Bundesbank's position that EMU should be a far-off goal, Kohl could not commit without them from such a weak political position. So while Mitterrand was demanding that the German government commit itself to monetary union, Kohl met with the leaders of the major German firms as well as industry and banking organizations to discuss the new situation and to try to convince them that support for EMU was necessary in order to bring about rapid unification.[41] By the time

of the Strasbourg summit, Kohl was able to secure the crucial support of the leadership of the BDI, the DIHT, and the BDB for the German government's agreement to the EMU design process.[42]

Why did the coalition supporting the Bundesbank's position suddenly collapse and several of the most important players switch sides and agree to the idea of an IGC to start designing the EMU project? The industry and banking organizations' primary interest in EMU did not change; they still saw it as a potential threat to German monetary stability. But when put as a dichotomous choice, EMU or no rapid unification, their preference was for agreeing to the start of the EMU design process. They perceived that the potentially huge gains from rapid unification outweighed the potential costs of the EMU project by a safe margin. The East German market was so enticing that they were willing to agree to a process of institutional creation that they would have otherwise resisted.

The Bundesbank did not foresee any windfall from bringing the former GDR into the Federal Republic; it did foresee a great threat to German monetary stability if EMU was created prematurely. The savings bank and savers associations (the DSGV, the BVR, and the GSDS), did stand to gain from unification, but they perceived they had more to lose from an ill-conceived EMU. But as these organizations stood alone vis-à-vis the Kohl government and its powerful coalition, they had little chance of blocking German acceptance of the IGC that would start amending the 1957 treaty and begin the EMU design process.[43]

Thus when Kohl went to the Strasbourg summit on December 8–9, he was able to agree to the French demands for setting a date for the IGC, despite the continued resistance of the Bundesbank and the conservative banking organizations. As a Foreign Office official put it: "Monetary union was part of the package deal delivered by Kohl for his goal of unification with the GDR."[44] The summit set the date for the IGC for December 1990, to be held in Rome.[45] By agreeing to that date, the German government had effectively committed Germany to the road to monetary union. The question was no longer if but how EMU would be designed.

Bundesbank Brinkmanship

The German government's agreement to the date for the IGC represented a serious political defeat for the Bundesbank and those who wanted to go slow on EMU. They now had to contend with the fact that European Monetary Union was no longer a theoretical concept to be debated. The next step was to lay the concrete blueprint that would make the EMU initiative reality. After the Strasbourg summit, there was no turning back from designing monetary union.

What were the choices available to the Bundesbank in the face of the German commitment to the design process? Overtly blocking the path was not a politically viable choice, as it would have undermined the Bundesbank's domestic support. The central bank knew it would have to be cautious not to appear to be trying to obstruct the EMU initiative because continued French cooperation was necessary in the process of negotiating the terms of German unification. As the GDR's economic and political collapse accelerated, German industry and banking associations pressed the German government, both privately and publicly, to achieve unification as quickly as possible.[46] Any Bundesbank move that could have delayed unification would be opposed by nearly all German state and nonstate organizations.[47]

Since the political route to negotiating EMU had been set, the choice the Bundesbank faced was how to achieve an acceptable EMU design. The bank chose a brinkmanship strategy aimed at getting monetary union on its terms. To be able to shape the German government's negotiating position, the German central bank went on the political offensive by taking a very public hard line on the terms it would accept for monetary union.

The Bundesbank substantially raised the political stakes of the EMU process in September 1990, when it issued its position paper for achieving monetary union with an eye on the German government position at the December IGC.[48] The central bank's position paper called for a tough series of convergence criteria to be fulfilled before the second stage to EMU could start. All eventual EMU members would have to participate in the ERM without capital controls. The position paper also called for "inflation to be very largely stamped out" and budget deficits should be reduced to low levels. The Bundesbank argued that admittance to EMU membership depended on achieving these criteria; if a country did not meet the criteria, it would have to wait to join the EMU. The central bank also explicitly stated that EMU should not be constrained by set starting dates, as monetary and economic convergence were the top priorities. The position paper called for the future European Central Bank to be modeled on the Bundesbank, but with institutional improvements. In the Bundesbank statement, the European Central Bank would be the sole authority for monetary policy and foreign monetary relations and its position would be clearly defined by law so that there would be no room for political conflict over its role. The Bundesbank position paper envisioned the ECB as being solely committed to price stability, without having to be made responsible for supporting economic policy, as in the German case. Most importantly, the central bank did not offer its position as a series of suggestions; it stipulated the conditions that the Bundesbank demanded if it were to accept the EMU project.

The Bundesbank hoped that by laying down its gauntlet, either it would get

EMU its way or the German or some other government would reject its conditions and the project would possibly die. In order to make sure its position would become the position of the Kohl-Genscher government in the negotiations, the Bundesbank needed political support. That meant arranging a coalition of industry and banking and any other organizations that would be able to shape the government's position on the institutional design of the future monetary union.

The Bundesbank met with the leaders of most of the relevant peak associations and ministries to garner support for its plan to define the German position on EMU negotiations. The central bank did not have much difficulty in finding German organizations that were willing to side with its attempt to create EMU on its terms. Those that had decided to support the chancellor's decision to agree to the IGC, such as the BDI, the DIHT, and the BDB, had not made that choice with the intention of giving the government carte blanche in the design process. Considering the instrumentality of their support for EMU, it is not surprising that they quickly moved to a position of open support for the Bundesbank's hard-line stance. With French agreement to rapid German unification secured as long as the Federal Republic backed EMU, the German industry and banking organizations' new priority was to ensure that their agreement to the EMU process did not endanger the future of the domestic German monetary paradigm.[49] The organizations that had consistently supported the Bundesbank position on EMU, namely the savings bank associations, reaffirmed their support for the Bundesbank's hard line.[50] The only nonstate organizations not to line up solidly with the Bundesbank's tough "economist" stance were the Farmers Association and the DGB, which believed the Bundesbank was stalling on EMU.[51]

Not surprisingly in view of the Bundesbank's strong state and societal organizational backing, Kohl came out to support the Bundesbank position on EMU.[52] Kohl was busy trying to hold off the French government from rushing Germany to EMU while at the same time placating it so that unification could proceed unimpeded. Well aware that the Bundesbank had powerful support for its position from most major nonstate organizations and the German public, Kohl was not willing to agree to a French demand that the design negotiations for EMU be pushed forward.[53] Kohl also continued his campaign to push for European political union to accompany the monetary union, as advances in political integration were deemed necessary by most German organizations to ensure that they knew in what political context the future European Central Bank would operate.[54] Genscher, on the other hand, pressed for setting a near-term date for the creation of the European Central Bank.[55]

The Bundesbank's brinkmanship gamble seemed to pay off. At the Rome

IGC summit in December 1990, the German negotiators faithfully represented the Bundesbank position on the ECB's independence and the convergence principles. But as the IGC continued to work on the text of the EMU treaty, the Bundesbank and its industry and banking allies worried that Kohl would "sell the Bundesbank out" in order to appease the French government, which was becoming increasingly aggravated by German demands.[56] This fear was heightened by frequent comments by Genscher which seemed closer to the French "monetarist" position than to the Bundesbank's "economist" position.[57]

As the decisive December 1991 Maastricht summit approached, the Bundesbank and its coalition of the BDI, DIHT, and banking organizations stepped up their private and public pressure on the German government not to stray from the Bundesbank's EMU requirements despite disagreements with France and Italy, which disliked the idea of no timetable and a two-speed EMU that would probably leave the Southern European states out of the monetary union for a substantial period.[58] The BDI and the DIHT were the Bundesbank's most important and vocal nonstate supporters.[59] They claimed that German industry had little to gain from EMU in terms of reducing transaction costs, but had an enormous amount to lose if EMU threatened price stability and would thus not accept compromises on monetary union.[60] They made this clear both in their official positions and in their meetings with Chancellory officials. Bandwagonning, the SPD and DGB stepped in to lend mild support to the Bundesbank's and Finance Ministry's "economist" position.[61]

Although the treaty resulting from the Maastricht summit reflected many "economist" points demanded by the Bundesbank, the German delegation, consisting of Genscher, Kohl, and Waigel, agreed to significant "monetarist" provisions.[62] First, the German delegation, at Italian suggestion, accepted dates for moving to the third stage of EMU. Second, the German delegation agreed to formally reject the concept of a multistage EMU, although the provisions of the treaty leave it open as a possibility. Third, the Germans at Maastricht agreed to a future review conference that offered the possibility that the economic and monetary criteria could be overruled by political choice.[63]

Why did German negotiators switch from a hard-line "economist" to a somewhat "monetarist" position at the summit? The answer lies in the Foreign Office's and Chancellory's consistent preference for achieving EMU at a speedy pace rather than through the difficult and potentially painful process of convergence envisioned by the Bundesbank and other "economist" advocates. German Chancellory and Foreign Office negotiators looked at the Maastricht summit as a window of opportunity for speeding up European integration in order to convince Germany's neighbors of its good intentions and to win domestic political points. Ever since the EMU initiative was first proposed in Janu-

ary 1988, Kohl and Genscher agreed with the French position that EMU needed the political pressure of a timetable in order to be achieved. A senior Foreign Office official says this about the German negotiating position: "We took it as a wholly political step. The dates were meant purely for political pressure in order to realize monetary union."[64]

Thus at the Maastricht summit, where neither the Bundesbank nor any peak organization representatives were present, German negotiators from the Foreign Office and Chancellory took the chance to negotiate according to their preferences. Waigel was apparently overruled by his two counterparts. The change in the German negotiating position was the result of German negotiators believing they were free to negotiate as they wished; there was no change in the international environment that caused them to change their position. In fact, German negotiators were in a stronger position vis-à-vis the French and Italians than they had been during the pre-Maastricht period when they had taken the hard-line "economist" position. Unification had been achieved in October 1990, and Germany's EC partners had no new bargaining chip to use to extract concessions from the German negotiators.

The German negotiators figured that the "monetarist" provisions in the treaty would raise grumbles from the Bundesbank but the German public would support the bold new move ahead in European integration. A Foreign Office official argues this was a significant miscalculation: "What came as a surprise was how the media and public reacted to this. The anti-EMU voices in the public only came after the signing of the Maastricht Treaty."[65]

The "monetarist" provisions in the treaty prompted an outcry from officials of the Bundesbank and from industry and banking organizations and led to the nearly hysterical public reaction in Germany toward EMU after the Maastricht summit. The institutional design for EMU laid out in the treaty text represented a mixed outcome for the Bundesbank coalition.[66] The Bundesbank had gotten what it wanted on many aspects of monetary union. In many ways the Maastricht Treaty represented an improvement on the institutions that define the Bundesbank's role in the German political economy,[67] one of the most important being that the new ECB would not be obligated to support the economic policy of EC governments. The central bank would be strictly committed to price stability. But the timetable and the possibility of a political override of the convergence criteria, decided when the German negotiators were alone with their counterparts at Maastricht, were disconcerting to the central bank as well as the industry and savings bank organizations.[68]

Another major problem in the treaty for the Bundesbank as well as its societal organizational allies was that it laid out the fiscal policy hurdles to get into EMU but there was no mechanism for ensuring that countries would stick to

fiscal discipline once they had achieved admission. This opened the possibility that states would "behave" before getting into EMU and then move to expansionary fiscal policies once in. Such a scenario would mean inflation would develop through the monetary union.

Despite the serious reservations held by many organizations in Germany after the Maastricht negotiations, the Bundesbank and the industry and banking organizations pledged their support for the process outlined in the treaty. Despite this pledge, these organizations warned of the dire economic consequences for Germany if the government did not follow the convergence criteria. This meant that the treaty ratification process was never seriously threatened, and it was ratified by the German parliament on 3 December 1992.[69]

Post-Maastricht Policy Changes

The alarmed reaction of the industry and banking organizations to the Maastricht Treaty proved a serious challenge to the Kohl government. Without the confidence of industry or banking organizations, the path to monetary union would possibly be very damaging to the German economy as well as to Kohl's political support. Economic damage would result if doubts about EMU were to lead German industry to abandon production in Germany and move operations outside Europe to avoid being entangled in a failed monetary union.[70] Kohl also had to worry about how the public would hold him responsible for giving up the deutsche mark, in that the industry and banking organizations were making German policy toward EMU a public issue with a press campaign to constrain the German government.[71]

The public reaction to the Maastricht Treaty was surprisingly negative considering the placidity of the public during the negotiations over EMU. Directly following the negotiation of the treaty in December 1991, opinion polls showed the German public's negative reaction to the idea of replacing the deutsche mark with a European currency, with over 50 percent against the EMU plan. To the dismay of the Kohl government, this negative attitude only increased over time. By May 1996, only 40 percent of those polled were willing to give up the deutsche mark for the European currency.[72]

Why was the German public so negative toward the EMU project? Two factors were particularly important in explaining why average Germans were so negatively predisposed to the idea of monetary union. The first factor was the largely negative press attention to the Maastricht Treaty following its negotiation. Banking and industry organizations came out to criticize portions of the treaty they thought could potentially threaten domestic price stability. Their press campaign to constrain the government raised the level of public concern

over what the German government had agreed to at Maastricht.[73] The second, and most important, factor was how the German public valued the deutsche mark. The deutsche mark was viewed by most Germans as a symbol of Germany's postwar economic prosperity, and that view meant that the German public was very concerned that giving it up would threaten their economic well-being. A survey completed in 1996 showed that 71 percent of Germans polled thought the entry into EMU would personally disadvantage them; only 25 percent expected to be better off.[74]

The negative attitude within the German public toward EMU presented a serious problem for the Kohl government. The decision to enter EMU in 1999, as called for in the Maastricht Treaty, would have to be made by early 1998, at the latest. This was bad timing, as it would coincide with the campaign for the German general election in 1998. Considering the possible negative electoral consequences of public resistance to the EMU plan, the Kohl government had not only to keep the support of banking and industry organizations for EMU, but change public attitudes toward monetary union.[75]

One of the principal issues in the German debate over the path to EMU concerned which countries would join Germany in EMU in 1999. Many in Germany argued that a small union of the "hard core" of low-inflation EU countries should precede a larger union of all EU countries.[76] This idea found strong support from German banks and some firms, which believed that the EMS crisis had made it apparent that a large union à la Maastricht looked very doubtful. By having a small union first, the convergence criteria would not have to be softened and the benefits of monetary union could be achieved.[77] The central bank also called for a two-speed monetary union, where the strong-currency countries would join first and weaker-currency countries would join once they had fulfilled the convergence criteria of the Maastricht Treaty. While this did not directly contradict the Maastricht Treaty, it did put the Kohl government in a difficult position; the government would either have to show solidarity with all EU member states and argue for a one-speed union, or placate the Bundesbank and the financial and industry community in Germany by supporting the idea of a possibly multispeed union. Kohl chose to not rule out a multispeed union.[78]

In the wake of the 1992–1993 EMS crisis and transformation, the Bundesbank continued its offensive to shape German policy toward EMU. In May 1994, the president of the Bundesbank, Hans Tietmeyer, argued that the conditions set down in the Maastricht Treaty would have to be met at all times after the beginning of EMU and not just in periods of economic boom. Thus countries should *never* be allowed to overshoot the 3 percent of GDP budget deficit ceiling set down in the treaty.[79] Tietmeyer's call for a union of core states and a

tough line on the convergence criteria after the start of EMU was supported by organizations such as the Federation of German Industry and the DIHT as well as savings bank organizations. This tacit coalition allowed the Bundesbank to be confident in pressuring the Kohl government to take a tough stance on EMU. With such a powerful set of partners, the Bundesbank's position could not be ignored.

The pressure on the Kohl government from the Bundesbank and its industry and banking allies eventually had its desired effect. In November of 1995 Finance Minister Waigel called for measures to prevent countries from running budget deficits after they joined EMU. Waigel called for a "Stability Pact" between EU members whereby any state that exceeded the budget deficit prescriptions would have to pay a substantial fine, the amount being subject to negotiation.[80] Waigel hoped that these new suggested measures would assuage the fears of the German savings banks and industry organizations as well as the German public.

The new demands by the Bundesbank and the Finance Ministry after the signing of the Maastricht Treaty represented a problem to Helmut Kohl. The worry in the Chancellory was that the new demands would be interpreted by the French and others as German foot-dragging or, worse, an attempt to scuttle EMU.[81] Due to domestic pressures, Kohl took the stance that stability would have to be assured after EMU began in 1999 and he backed Waigel and the Bundesbank in their effort to get other EU leaders to accept the Stability Pact.[82] In December of 1996 at the Dublin summit, EU finance ministers agreed to support the pact, although it was rechristened the "Stability and Growth Pact" at French insistence.[83] The Bundesbank, the Finance Ministry, and societal organizations concerned about stability after the start of EMU got the pact they had wanted.[84]

The key issue facing German organizations in the end-run to the 1999 EMU deadline was whether to abide literally by the entrance criteria laid out in the Maastricht Treaty or show flexibility in starting EMU. In 1997, it looked like only one country, Luxembourg, would be able to meet all of the convergence criteria by 1998, when the 1999 EMU participants would have to be named.[85] Germany itself would likely be over the budget deficit limit. This led to a fierce debate about how to deal with the convergence criteria and the EMU timetable.

The side of staunch adherence to the convergence criteria was led by the Bundesbank. Bundesbank President Tietmeyer and North-Rhine Westphalia LCB President Reimut Jochimsen made frequent statements in the press to the effect that it was better to postpone EMU's start than have it be a disaster that started on time.[86] This Bundesbank position was supported by the DIHT and the savings banks.[87] These organizations had consistently supported

the Bundesbank's position that the stability of the new currency had to have priority over any deadline. The DIHT was concerned about the convergence criteria issue because the majority of its members, small firms, saw little gain from EMU. In fact, the support for EMU was inversely proportional to the size of the firm.[88]

But the central bank was joined by a rather strange bedfellow in the form of Social Democrats. Some in the SPD sided with the Bundesbank because of the potential electoral gains of that position. After its disappointing loss in the 1994 general election, some in the SPD, most notably Gerhard Schröder, Minister President of Lower Saxony, searched for issues that would distinguish them from the CDU and gain votes; EMU was seen as just such an issue. Thus, seeing the negative public attitude toward EMU, some SPD politicians broke with the long-standing interparty consensus on European integration and came out to oppose a quick move to EMU.[89]

The Chancellory, Finance Ministry, and Foreign Office led a group of organizations committed to bringing Germany into EMU in 1999, even if it meant significant cuts in public spending. While arguing that the convergence criteria were important, and that it was obvious that EMU would be a multispeed process, these organizations claimed that if Germany did not enter monetary union with the other "core" countries in 1999 two negative consequences would result.[90] First, the political impetus would be lost with a postponement and that would possibly kill the project. If EMU did not take place, European integration could regress, argued Kohl, Waigel, and Foreign Minister Kinkel.[91] They also argued that the collapse of the EMU project would lead to a pronounced appreciation of the deutsche mark, causing German exports to become too expensive and causing the loss of thousands of jobs.[92] Obviously, they saw the timetable as the top priority.

The Chancellory and Foreign Office were joined by an assortment of organizations in support for holding to the EMU timetable. One organization that consistently supported the scheduled move to EMU was the Association of German Banks (BDB). It stood to make strong inroads into the European banking market but it also stood to make great losses if EMU did not go off as planned. The risk was that German banks had to prepare long ahead of time for EMU and if it was postponed, the investments in preparation would have been lost. These interests made the BDB a very vocal supporter of the prompt start of EMU.[93] The chancellor's policy coalition, like the Bundesbank's, had some strange bedfellows. The DGB supported the prompt move to EMU as a way to get out of the Bundesbank-dominated EMS.[94] Another strange bedfellow, the Greens, supported the EMU timetable as crucial to further European integration.[95]

Another startling addition to the chancellor's policy coalition was the BDI.

Originally one of the organizations wary toward the Maastricht blueprint for EMU, the BDI's enthusiasm increased in 1996. Instead of continuing to back the Bundesbank's position that postponement should take place if the convergence criteria were not strictly achieved in 1998, the BDI took a position that the criteria should be flexibly interpreted.[96] The reason for this change of position was the costs that a postponement would inflict on large German firms. Large firms, which depended a great deal on exports for profits, saw sizable gain to be had from EMU in lowering transaction costs. But another, perhaps more important, factor was that these firms had already begun to prepare for EMU in the form of new accounting procedures. Like the large banks, these firms stood to take great losses if EMU did not start as planned. Therefore, the BDI, which is dominated by large firms, moved away from the position of the DIHT, its usual ally.

Also, domestic economic problems in Germany have created doubts within Germany and throughout Europe that the German government will be able to keep to the January 1999 start date. Germany's unemployment rate of 12 percent in 1997 and doubts about getting its budget deficit below 3 percent of GDP in 1998 were factors that had many speculating that the German government would call for a postponement for the start of EMU. Banks and firms are not sure what to do about getting ready for EMU because of the uncertainty of its future. A survey by the DIHT in March 1997 showed that only 21 percent of German firms had begun preparations for the introduction of the euro, the planned European single currency.[97] This pattern seems evident throughout the EU. This lack of preparation could leave many European firms and banks in a very precarious position come January 1999, the established date to start EMU.

What these two policy coalitions meant was that the German government's stance toward EMU as it moved toward the 1999 deadline did not represent a coherent policy position. While Kohl, Waigel, and Kinkel wanted to start as planned, the Bundesbank called for a strict adherence to the criteria for EMU and a postponement if the criteria of the Maastricht Treaty were not literally fulfilled.[98] Clearly, the German government's diffuse responsibility for questions of international monetary regimes and the large role German societal organizations could play in pressuring German state organizations was making it very difficult to create a stable, consistent German policy on EMU.

Conclusion

The EMU episode has shown that changes in the international environment can be crucial to changes in domestic political coalitions related to inter-

national institutional choice. When the international environment changes, international institutions may serve to increase either the costs or the gains to organizations associated with such changes. Thus changes in the international political or economic environment can be important catalysts for international institutional change. Changes in the international environment and the way they affected domestic coalitions within Germany were central to the changing German government position on the EMU initiative. But it was not the altered international environment that was the direct cause of the changing German government. Changing domestic coalitions were the crucial factor in German policy change. Organizations chose their sides based on what EMU, as a set of international institutions, held in store for them. The state-societal organization coalitions that formed on the issue did not base their actions on a sense of the national or even a class interest. Their actions were clearly motivated by expectations about distributional outcomes associated with monetary union.

The seemingly confusing nature of changes in German policy following the Franco-German EMU-for-unification deal have been a direct result of the diffused responsibility for policy toward international monetary institutions in the German polity. In the 1990–91 IGC the Bundesbank and the Finance Ministry seemed to dictate policy. Then at Maastricht, the Chancellory, the Finance Ministry, and the Foreign Office all had a hand in defining the German position. Following the Maastricht summit, it was difficult to determine which was the official German position. This diffusion of policy power goes a long way in explaining why the politics of European Monetary Union has been so tumultuous.

6 The Price of Change: German Policy and the Transformation of the EMS

The EMS worked very well as long as capital movement was constrained. The "monster" of international capital flows killed the EMS.
—German banker, 1993[1]

Over the weekend of 30 July–1 August 1993, the finance ministers and central bank governors of the European Community met in Brussels to find a solution to the most severe crisis in the history of the European Monetary System. On Monday, August 2, the meeting participants announced that the exchange rate bands of the EMS would be widened from +/– 2.25 percent or 6 percent to +/– 15 percent.[2] The EMS was transformed from a system of fixed, yet adjustable, exchange rates into a zone of more or less floating currencies.

The German Ministry of Finance, in its official commentary following the EC decision, referred to the institutional transformation of the EMS as "liberation for the Bundesbank."[3] What is perplexing about this statement was that it was made by the same German government that just a year earlier had defended the EMS from its critics as a monetary regime that functioned very well and was in no need of change. This statement was also made by a government that had hailed the Maastricht Treaty as a "triumph for Europe." The transformation of the EMS into a system of ostensibly floating exchange rates seriously called into question the viability of the EMU process as outlined in the Maastricht Treaty. So what lay behind the German government's apparent switch from its enthusiasm for the EMS status quo and the Maastricht Treaty to an attitude of relief that the old institutions of the EMS had for all intents and purposes collapsed, and EMU seemed in jeopardy?

I argue that the change in German policy can be explained by examining changes in the domestic effects of the monetary regime in 1992–93. The EMS, as an international institution, constrained the policy options available to German state organizations, namely the Bundesbank, to deal with the consequences of German unification. In 1992–93, because of increasing international

capital flows, the costs of maintaining the rules of the EMS rose to such an extent for those actors that they chose to change the institutions of the monetary regime. It took until the summer of 1993 for German policy to change, despite rising policy costs to the Bundesbank starting in the fall of 1992, because it took that long for the Bundesbank to assemble the necessary policy coalition to make EMS institutional change the official German policy, a delay that was a consequence of the large number of state actors responsible for this policy area.

The Costs of Unification

Unification fundamentally changed the domestic German political-economic environment. It has been by far the single greatest shock to hit the German economy since the creation of the Federal Republic. Unification posed economic and political problems that were of a far greater magnitude and complexity than those brought about by the oil crises.

The union of the two German economies on 1 July 1990 opened a Pandora's box of problems. One of the most severe predicaments was brought about by the conversion of the East German currency into deutsche marks.[4] The 1:1 exchange rate policy for the two German currencies produced what Bundesbank President Pöhl referred to as a "disaster."[5] The currency conversion caused an enormous cost push for East German firms relative to their West German counterparts. Overnight, East German firms saw their costs of production rise by 400 percent as real East German wages soared. This huge inflationary surge gave many East German firms no chance of survival, as their productivity came nowhere close to the wages their workers now received. The result of this increase in production costs was what Treuhand chairman Detlev Rohwedder called a "catastrophic change in output potential" for East German firms. Just in the first two weeks of economic and monetary union 200,000 workers were let go. In fact, the resulting collapse of East German firms was the largest contraction any industrialized economy has ever seen. In 1991, the east German economy contracted by 30 percent and the east German workforce shrank from ten million in 1989 to six million by 1992.

But the monetary conversion aspects of unification were not the only causes of Germany's economic problems. The decision to rapidly bring east German wages up to west German levels also proved a significant source of rising unemployment and the lagging competitiveness of east German firms. West German unions and their newly acquired east German members called for rapid moves to equalize east-west German wage rates by 1995. German unions argued that increasing east German wage levels would diminish the westward migration of east Germans. But a barely concealed motivation on the part of west German

unions, as well as employers' associations, was a fear of competition from a low-wage east Germany. East German wages were rapidly raised following unification, having reached 80 percent of west German levels by 1992, although east German productivity was between one-half and one-third of west German levels. This wage increase greatly added to the difficulty of slowing the growing rate of east German unemployment and heightened the problem of inflation in the east, which ran at around 15 percent in 1991 (see Sinn and Sinn 1992).

Privatizing the east German economy also proved to be a tremendous problem.[6] The decision to restore property rather than compensate the former owners resulted in a property rights bottleneck. Almost 90 percent of east German firms had conflicting claims, a situation that severely hampered the rate of investment into east Germany. The result was that the capital needed for the "economic miracle" promised by the Kohl government was not forthcoming and the recession in the new German states was exacerbated.

The collapsing east German economy following economic and monetary union in July of 1990 quickly became the responsibility of the unified German government. In light of the growing crisis in the new eastern states of the Federal Republic, the Kohl government undertook a program of huge transfer payments to subsidize east German firms and pay for east German unemployment benefits and other costs the new states were not able to cover themselves. In 1990 the amount of transfers was DM 46.2 billion, in 1991 DM 131.8 billion, and by 1992 they had reached the staggering sum of DM 163 billion (Heilemann and Jochimsen 1993). To pay for the transfer payments to the eastern Länder, the German government borrowed heavily and raised west German taxes (euphemistically referred to as the unity surcharge).

As German economic policy following unification focused on transfer payments to eastern firms to keep them afloat, German monetary policy was geared toward fighting the inflationary effects of those same policies. The Bundesbank, displeased with wage settlements in several sectors of the German economy following unification, as well as the scale of government expenditures to finance the program of aid to the eastern states, reacted with a combination of warnings and an increasingly tight monetary policy in 1991 through 1992.[7] The Bundesbank began its trend of seriously tightening monetary policy in 1991 by raising the discount rate from 6.5 percent to 7.5 percent in August and further raised the rate to 8 percent in December. It reached its peak in July 1992 when the central bank raised the discount rate from 8 percent to 8.75 percent (the highest rate since the founding of the Federal Republic) despite signs that western Germany was about to slip into recession.[8] Figure 6.1 shows the trend of German discount rate increases from January 1991 to August 1992.

The Bundesbank justified its tightening of credit by arguing that monetary

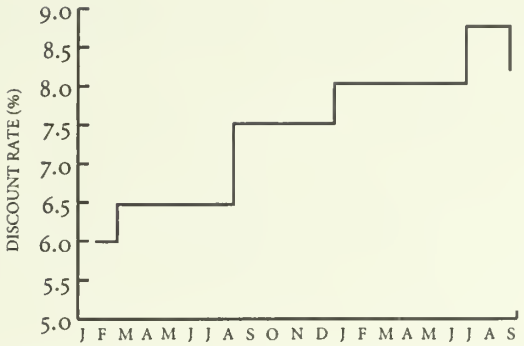

Figure 6.1 Bundesbank Discount Rates, January 1991–September 1992. *Source:* Deutsche Bundesbank

expansion in both the eastern and western Länder due to increasing wages, government transfer payments to the east, and a boom in east German demand for west German goods following unification was fueling inflationary pressures.[9] Having set a monetary supply target of 3.5 to 5.5 percent growth for 1992, and observing money supply growing at an annualized rate of 9 percent, the central bank argued it had every reason to tighten credit. The Bundesbank claimed: "The east German economy is almost totally shielded from the effects of interest rate policy. This impairs the efficacy of monetary policy instruments and the monetary braking distance becomes longer."[10]

In regard to its EMS partners, the Bundesbank rationalized that its tight monetary policy was its "contribution" to the Maastricht process by creating a low inflation zone for all the EMS members.[11] But at all times Bundesbank made it clear that its domestic situation would take priority over the needs of its European partners.[12]

German domestic reaction to the Bundesbank's severely tightened monetary policy was overwhelmingly negative. A spokesman for Dresdner Bank called the Bundesbank's discount rate hike "brave but wrong." Industry organizations such as the BDI, which usually backs Bundesbank policy, criticized the tightening, saying it risked damaging Germany's economic performance and particularly had the potential to block the upswing in the new Länder.[13] Even the BVR, usually a staunch Bundesbank supporter, complained to the bank about its tightening monetary policies. A BVR functionary had this to say about monetary tightening: "We felt the Bundesbank had gone too far with its monetary policy. We went to the Bundesbank discreetly and asked the central bank to reconsider its policies because of their very negative economic consequences."[14]

This presented the Bundesbank with a serious political dilemma, along with what it viewed as a threatening monetary situation. Without the support of industry and banking organizations, the central bank was aware that it would not be able to maintain its tight monetary policy for long without threats to its autonomy.

The most serious criticisms of the Bundesbank's monetary policy came from the Federal Republic's EMS partners. Gripped by a persistent recession, France and Britain braced themselves for even harder economic times in the face of higher German interest rates.[15] The Italians feared that the Bundesbank's tightening policy would put the lira under increased pressure and make keeping the currency from hitting the floor of the ERM more difficult. Thus, having to follow the Bundesbank's lead to more restrictive credit not only threatened economic recovery for Germany's EMS partners; it created tensions within the ERM that were bound to lead to an exchange rate crisis if realignments were not forthcoming.[16]

International Capital Liberalization

Perhaps the most important development for the functioning of the EMS in the early 1990s was the liberalization of international capital markets. Spurred on by domestic political pressures, major financial centers such as New York, London, and Tokyo, as well as several others, moved to make financial transactions easier and to lift the restrictions on their capital markets (see Sobel 1994; Strange 1986).

This resulted in a tremendous increase in international capital flows, as it became easier for financiers, as well as speculators, to use large sums of capital for their transactions. The volume of activity in world currency markets increased by 116 percent between 1986 and 1989 and 44 percent between 1989 and 1992. This far outpaced the growth in world trade in commodities. In fact, world commodities trade was only 2.7 percent of world currency trade in 1991 (Busch 1994, 89). The European Community also undertook measures in the 1980s to free the movement of capital between member states. In 1988, the EC Council of Ministers agreed to generally abandon capital controls within EC member states by July 1990. Up to that point, several EMS member states with weaker currencies had depended on capital controls to avoid large-scale speculation against their currencies. It was argued that there could be no complete internal market without fully integrated financial markets (Ungerer 1990, 349). This move was seen as an integral part of the Internal Market Program and was also considered stage one of the EMU project. France and Italy abolished their capital controls by the 1990 deadline, whereas other weak-currency

states (Greece, Ireland, Portugal, and Spain) were given until 1992. An IMF report by Goldstein et al. (1992, 2) said this about EC and international financial deregulation:

> Although the evolution of finance into a competitive international industry progressed gradually during the 1980s, the process gathered speed during 1991. Not only did the European Community's Single Market in financial services—perhaps the most ambitious and comprehensive financial-sector reform undertaken in recent history—near completion, but the next stage in U.S. and Japanese banking reforms also got under way in earnest. As a result, by 1992, domestic financial markets particularly wholesale markets, have become adaptive and international, with segmented financial structures increasingly giving way to broader-based, more integrated ones.

The growth in the volume of trade in currency markets occasioned by international and European capital liberalization has important implications for monetary and economic policy. Many economists and policy makers became wary of the potentially destabilizing effects that large-scale capital movements would have on the EMS (see Giavazzi, Micossi, and Miller 1988; Giovannini and Mayer 1991). The large increase in the availability of capital and the new innovations in financial instruments lowers the costs to speculators and raises the costs to central banks for maintaining stable exchange rates. Speculators are no longer bound to focus on the economic fundamentals of the member states; they can speculate against currencies based on what political factors could potentially do to the value of currencies, without the caution of the past because of the lower potential costs to themselves (see Bodner 1990). As one senior Bundesbank official later said: "With the fall of capital controls, speculators could set bullseyes on currencies, with little fear of getting burned themselves."[17]

Whereas the costs to speculators would decrease substantially because of capital liberalization and financial innovations, the potential costs to the EMS member central banks increased dramatically. The amount central banks would need to intervene in currency markets to maintain their currencies' parities would rise, as there were no longer institutional limits such as capital controls on the amount of speculation that could be directed at a currency. Central banks were faced with the situation in which their currency reserves were dwarfed by the potential capital flows in international currency markets. The possibility existed that the amount of speculation against currencies would outstrip the reserve capabilities of the EMS central banks to maintain the ERM parities. Despite the possible dangers that capital liberalization posed

in the EC exchange rate regime, proponents of EC capital liberalization were convinced that there had been so much convergence of economic fundamentals among EMS members since 1979 that capital liberalization was not a threat to the smooth functioning of the exchange rate regime. The transformation of the EMS within three years of EC capital market liberalization was to prove them wrong.

Prelude to Institutional Change: The Autumn 1992 Exchange Rate Crisis

Several factors came together in the autumn of 1992 to cause an exchange rate crisis that shook the EMS to its foundations and put the future of European monetary integration in question. Although the crisis resulted in two EMS members, Britain and Italy, exiting the regime, the effects of the crisis were to prove more profound than that. The 1992 crisis was the precursor to the transformation of the EMS from a fixed rate regime to a more or less floating system.

The most proximate cause of the 1992 crisis in the EMS was the speculative pressures building against weak currencies in the regime. These pressures increased in late August and early September of 1992 as the French referendum on the Maastricht Treaty approached. As it was uncertain what the outcome of the referendum would be, many currency dealers took the opportunity afforded by the existing tensions in the EMS to speculate against the currencies most likely to fall should a "no" vote result. The speculators' sights were set on the British pound, which had entered the ERM in 1990 at an overvalued level, as well as on the French franc and the Italian lira.[18]

As the speculation against those currencies continued to mount and the tensions in the ERM continued to grow, the political pressure on the Bundesbank to lower its interest rates became intense. In an attempt to persuade the Bundesbank to lower its rates to prevent a crisis in the EMS just before the French referendum, Chancellor Kohl went to the central bank's headquarters on September 11 to make his case. The decision that came from that session was that the Bundesbank would trade a cut in its discount rate from 8.75 percent to 8.25 percent and its Lombard rate from 9.75 percent to 9.5 percent for a 7 percent devaluation of the lira on September 14.[19] The Bundesbank was willing to make this swap because its interventions to save the lira were mounting.[20] But instead of announcing the rate reduction itself, the Bundesbank was preempted by Finance Minister Theo Waigel, who announced the reduction-devaluation swap on German television the weekend before the move.

While the Bundesbank move was greeted enthusiastically by Germany's EMS partners, the rate reduction received a more mixed reaction within Germany.

Daimler Benz and Commerzbank came out in support of the move, saying that it would provide a much needed boost for the German economy. But the Bundesbank's usual staunch allies, the DIHT and the DSGV, and the saving's bank association, were vocal in their displeasure with the move. Helmut Geiger, the president of the DSGV, pointed out that the move made no sense in terms of German economic fundamentals. Inflation was on the rise, the money supply was growing, and the government's budget deficit was also increasing. He expressed concern that the Bundesbank's independence had been undermined, particularly in light of Waigel's announcing the rate cut instead of the central bank. The DIHT was even more pointed in its criticism, arguing, like the DSGV, that the cuts made no sense other than to appease Germany's EMS partners. The DIHT warned that it would watch "to see that the independence of the Bundesbank is properly protected."[21]

The Bundesbank found itself in a very embarrassing situation. Although the economic and monetary situation in Germany was about the same as it had been in July when the central bank had raised rates, it now had to explain why it would lower them without an improvement in domestic conditions. Bundesbank President Helmut Schlesinger pointed to the interventions of DM 26 billion that the Bundesbank had to provide to save the lira, which were consequently bloating the German money supply.[22]

Despite the Bundesbank's interest rate cuts, the crisis in the ERM continued. Schlesinger did not seem to help matters when in an interview on 16 September with the German *Handelsblatt* newspaper and the *Wall Street Journal* he said that, despite the realignment, the problem was not definitively solved and some currencies could still come under pressure. He claimed a more general realignment would relax the situation.[23]

The following day the pressure on the pound and lira became so intense that, despite Bundesbank interventions to save them, they fell through their ERM floors and were pulled from the Exchange Rate Mechanism.[24] Waigel and Schlesinger were quick to point out that Germany could not be blamed for the EMS crisis and the exchange rate regime continued to function despite sterling's and the lira's exits.[25] The exit of the two currencies as a way out of the EMS crisis was greeted by all German political and economic organizations.

The German Monetary Policy Dilemma

The autumn 1992 exchange rate crisis presented a series of disturbing lessons for the Bundesbank, the German Finance Ministry, and other stability-oriented organizations in Germany. The crisis reaffirmed the Bundesbank's fears that the politically mandated rigidity of central parities in the ERM was a

Table 6.1 Bundesbank EMS Interventions in DM, 1979–1992

Year	DM billion	Year	DM billion
1979	+8.2	1987	+25.4
1980	−10.5	1988	0
1981	+15.0	1989	+3.0
1982	+3.7	1990	−1.6
1983	−7.8	1991	0
1984	+3.6	1992	+110.6
1985	−0.2	of which:	
1986	−6.6	September	+92.7

Source: Deutsche Bundesbank

threat to the stability of the regime. Instead of allowing the pressures on currencies to dissipate by realigning their central rates in a timely fashion, member states had waited until the point where a crisis had developed and speculators saw little risk in attacking the weak currencies. Whereas the Bundesbank had been able to convince the German government to call for a realignment of the lira, such a realignment with the French franc was not politically possible. The French government had made it clear following the acrimonious realignment of 1987 that such steps were a severe wound to France's national pride and no longer an acceptable way to deal with Franco-German monetary tensions. This new informal rule of rigidity in central rates meant that if crises developed the solution would have to come either from interventions or monetary policy.

But the magnitude of the capital flows involved in the crisis of autumn 1992 presented the Bundesbank with a host of problems associated with using interventions and monetary policy to try to maintain the parities in the ERM. The volume of Bundesbank interventions was the largest the central bank had ever had to make. Some DM 92.7 billion was spent in supporting the lira, pound, and franc. Table 6.1 shows the 1992 EMS interventions of the Bundesbank in relation to other years during which Germany was in the EMS. As can be seen in this table, the September exchange rate crisis of 1992 was the greatest effort ever demanded of the Bundesbank to intervene to support EMS currencies; in fact, it was the greatest intervention the Bundesbank ever made in any international financial market, including the dollar market.

The most important consequence of such interventions in the eyes of the Bundesbank is the effect they have on the domestic money stock. The Bundesbank had this to say of the results of the autumn 1992 crisis on the German money supply:

> It can be said that bank liquidity and the money supply have regularly been bloated by speculation-induced inflows of funds from abroad. This poses problems for monetary policy, and ultimately for the anti-inflation policy of the Bundesbank. The recent turmoil in the EMS, in the wake of which the net monetary reserves of the Bundesbank and the net external assets of the banking system increased to an extent unparalleled in previous periods of speculation, once again made this clear.[26]

Table 6.2 illustrates the autumn crisis's effect on M3[27] growth in Germany in relation to other speculative crises in the EMS. As can be seen from the table, the monetary expansion in September 1992 was at least twice as large as any other monetary expansion caused by a speculative attack in the EMS. This unparalleled expansion of the money supply by foreign exchange intervention was a particular cause of concern for the Bundesbank and like-minded organizations because the central bank's policy instruments were not well suited to fending off such a speculation-induced expansion of the money supply, although most of the liquidity from the intervention was eventually absorbed. The central bank was faced with a huge inflow of money at a time when the German money supply was already overshooting its annual target. The expected continued large international capital flows also did not help the problem.

This presented the Bundesbank with a dilemma; it could lower interest rates and reduce the chance of a new exchange rate crisis in the EMS, but by lower-

Table 6.2 Monetary Trends in Selected Periods of Speculation and the Months Following Them, 1983–1992

Speculative Period		% change in M3
1983	Feb. to March	+10.8
	April to May	+2.8
1985	Dec. to 1986 April	+6.8
1986	April to May	+2.1
1987	Jan to Feb.	+9.1
	March	+2.4
1992	September	+27.0
	October	−2.4

Source: Deutsche Bundesbank

ing interest rates it would lose control of the domestic money supply. Lowering rates in the face of political pressure from its EMS partners would also erode the central bank's credibility. In other words, the monetary effects of German unification required a restriction of credit to squelch monetary expansion but such measures would induce crises in the EMS that would also lead to expansion in the money stock.

Despite fears of losing credibility or control of the monetary situation, the Bundesbank began a slow but steady process of lowering its interest rates in the fourth quarter of 1992. Until the September crisis, the central bank had focused on M3 growth and inflation as its criteria for setting interest rates. Bundesbank Vice President Hans Tietmeyer gave indication of the bank's intentions to loosen its monetary policy when he said in October 1992: "M3 is and will remain one of our important orientation points. But we know that there is currently a series of factors that have to be considered and respected."[28]

There were several reasons for the Bundesbank's loosening of monetary policy. Following the autumn crisis, the economic situation in the whole of Germany worsened. Growth in west Germany was expected to be below 1 percent by the end of the year and economists were projecting no growth or negative growth for 1993. Unemployment also increased from 5.6 percent in January 1992 to 6.0 percent by the third quarter of 1992.

This worsening economic environment led to tremendous pressure being exerted on the Bundesbank by both state and nonstate organizations within Germany. The DGB complained that the Bundesbank was "strangling growth in Germany and Europe,"[29] warning that if the Bundesbank did not lower its interest rates the French would have to leave the ERM and that would mean the end of the EMU plan.[30]

The Bundesbank was also coming under fire from its friends. It was criticized unusually harshly by the Finance Ministry, which admonished it to also consider economic growth and unemployment when it made monetary policy.[31] The BDI, DIHT, and the BDB used private channels to try to persuade the Bundesbank to moderate its monetary policy stance.[32] The central bank was also under intense pressure from the German and the French governments to aid in maintaining the deutsche mark–franc parity. As the parity was considered the core of the EMS, it was crucial that the franc not go the way of the pound and the lira.[33]

Aside from a worsening economy and increasing political pressure, there were developments on the public finance and wage fronts that indicated a potential decrease in inflationary pressures. In the face of a worsening economy, German unions agreed to a series of moderated wage deals. The federal government pledged to lower its expenditures in order to reign in its grow-

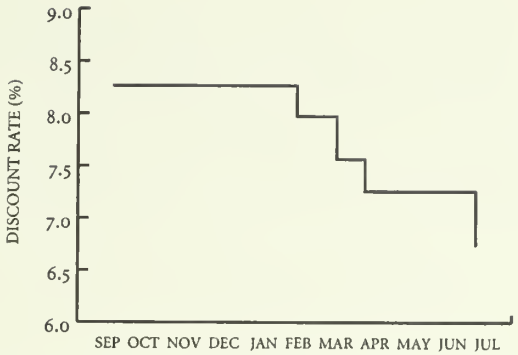

Figure 6.2 Bundesbank Discount Rates, September 1992–July 1993. *Source:* Deutsche Bundesbank

ing debt. Likewise, the Solidarity Pact between the political parties, labor, and industry to cooperate to lower the costs of rebuilding the eastern Länder indicated a resolve on the part of most important political and economic actors to restore fiscal discipline.[34]

The Bundesbank cut its interest rates slowly because of the fear of many in the bank that inflation was still a real threat. The monetary situation was still not encouraging; money supply growth continued to overshoot its target in 1992–93. But the most important reason for the go-slow approach was the central bank's fear of appearing to relax its monetary policy in the face of political pressure. Figure 6.2 shows the trend in German discount rates between September 1992 and July 1993.[35]

The Bundesbank's gradual loosening of monetary policy was greeted by the German government as well as the BDI and BDB as a welcome move for the German economy. The DGB, on the other hand, argued that the loosening moved much too slowly. The conservative Sparschützer Gemeinschaft, the DIHT, and the savings banks association criticized the Bundesbank for bowing to pressure.

The gradual reduction in German interest rates did not free German policy makers from the dilemma of balancing domestic monetary responsibilities with EMS commitments. The Bundesbank, the Finance Ministry, and German banking and industry peak associations all viewed the EMS situation as a serious threat to the maintenance of German domestic monetary stability. In meetings with the Bundesbank Directorate and the Finance Ministry, the BDI, the DIHT, and the organizations of universal and savings banks expressed their concern about the EMS's impact on the German political economy. All of these state and societal organizations agreed that something had to change in the

EMS before the regime was faced with another major exchange rate crisis. A senior BDI functionary has since said: "We believed the EMS had to be made more robust. It was not a question of making it more symmetric. The burden of adjustment had to lie with the weak currencies."[36]

Thus with the support of banking and industry organizations, the Bundesbank and Finance Ministry decided that EMS institutional change was the only way to free the Bundesbank from the increasingly dangerous burden of exchange market intervention.[37]

What were the institutional options available to the Bundesbank and Finance Ministry? Although they had always favored the return to timely realignments to provide the EMS the flexibility it believed was needed, realignments of the franc–deutsche mark parity were no longer politically possible. That meant that if speculation against the franc were to once again become a problem, the Bundesbank and the German government would have to consider other options to relieve the tensions in the EMS.[38]

The Bundesbank, acting as the vanguard of German state and societal organizations that desired EMS institutional change, began a campaign of open criticism of the functioning of the EMS. Bundesbank President Helmut Schlesinger announced in December of 1992 that the mechanisms designed to keep the EMS stable did not work. He argued that the obligations for central banks to intervene to support weaker currencies within the ERM were an invitation for speculators.[39] The Bundesbank called for changes in the intervention financing rules that had come out of the Basel-Nyborg agreement, which pressured the Bundesbank to intervene intramarginally and had cost the central bank dearly in times of speculation.[40]

The most favored option forwarded by the Bundesbank and the Finance Ministry at high-level, but informal, discussions of how to repair the EMS was to expand the fluctuation bands of the ERM.[41] Wider bands would make it more difficult for speculators to estimate the future rates for currencies and would thereby increase their risks. This would lower the speculators' propensity to bet against currencies, thus affording those currencies a more stable exchange rate. The Bundesbank would only broach this suggestion of institutional change in private, informal meetings because of the potential domestic costs of appearing to scuttle the EMU project by calling for a widened-band ERM. Because of this same reason, this institutional change was not supported by the French government. The Maastricht Treaty called for all EMS members to spend at least two years at the narrow +/−2.25 percent bands before monetary union.[42] The Bundesbank and Finance Ministry would have to wait until an opportunity presented itself wherein the French government would consider changing the institutions of the EMS.

The Transformation of the EMS

The exchange rate crisis of the summer of 1993 that precipitated the institutional transformation of the EMS did not come as a surprise to anyone, even as the Bundesbank lowered its interest rates in 1993. The autumn 1992 crisis had illustrated the increasing inability of EMS central banks to fend off speculative attacks on weak currencies. Attacks against weak ERM currencies continued throughout 1992 and 1993, leading the central banks of those countries to raise interest rates to maintain their parities.[43] Despite these efforts, most of the weak currencies still participating in the ERM were devalued in the months following the 1992 crisis.[44] Unless the flow of international capital was to somehow decrease or the tensions within the ERM caused by German monetary policy were relieved, it was only a matter of time before the franc–deutsche mark parity, the core of the EMS, would come under attack.

Ironically, it was the French government that acted as the catalyst for the second major EMS crisis that led to the institutional transformation of the regime it so much wanted to avoid. The Bundesbank's slow lowering of interest rates was not enough to avoid continuing tensions in the ERM. After a brief period of deutsche mark depreciation, the French government claimed that the franc would possibly replace the deutsche mark as the anchor currency of the ERM. The French government also decided to lower its interest rates to below German levels for the first time since 1987.[45] The lowering of French interest rates led speculators once again to take the franc in their sights in June 1993.

The French government resolutely stated that it would not accept a devaluation of the franc. The French economics minister, Edmond Alphandèry, claimed that the deutsche mark–franc parity was "an absolute imperative and the backbone of the construction of Europe." The French prime minister, Edouard Balladur, went so far as to say he would resign before he would accept any devaluation of the franc.[46]

The Bundesbank faced a situation in many ways similar to the autumn 1992 crisis. Speculation against a weak currency was growing at such a rate that interventions could do little to save it. But in this case, the currency in question was that of Germany's most important EC partner, and its government was not willing to consider a devaluation. The French government also would not consider raising their interest rates as an option in the face of their deteriorating domestic economic situation.

At this point the Bundesbank was adamant that the EMS could not continue in its existing form. The Bundesbank, the Finance Ministry, and German industry and banking organizations agreed that the EMS's institutions needed to be changed immediately to reduce the costs of currency market intervention in

the face of a new monetary crisis.[47] Although a widened-band EMS would possibly delay, if not scuttle, the EMU timetable, the Bundesbank was convinced it was necessary to maintain German monetary sovereignty. The Bundesbank and Finance Ministry decided to take the initiative to convince the French to agree to a widened-band EMS to overcome the exchange rate crisis. The Chancellory and Foreign Ministry gave their tacit consent to the Bundesbank's and Finance Ministry's plan to convince the French of the need for institutional change, but stayed on the sidelines to avoid having to confront the French government themselves.

In the hope of defusing the growing exchange rate crisis, French and German delegations met on 22 July in Munich to find a cooperative solution. Instead, the meeting demonstrated how far apart the German Bundesbank and Finance Ministry stood from the French government in their views on how to solve the crisis. De Larosière, the French central bank governor, asked the Bundesbank to cut its interest rates and to obligate itself to unlimited purchase of francs to prevent the currency from hitting its ERM floor. The Bundesbank replied that it was not in a position to do either of those things and suggested instead that intervention obligations in the ERM be lifted to stop the speculation. As neither side could convince the other of its position, the meeting adjourned with only an agreement to increase the Banque de France's swap credit with the Bundesbank.[48]

The fate of the ERM lay at this point in the hands of the Bundesbank's Central Bank Council, which was to meet on July 29. The only way the franc was not going to leave the ERM, economists believed, was if the Bundesbank were to lower its discount rate by at least three-quarters of a percentage point.[49] This left the Bundesbank with the following choices: it could lower its discount rate by three quarters of a point and perhaps relieve the pressure on the franc, keep its discount rate unchanged, or make a token cut. The first option had two definite downsides. First, by lowering the discount rate by such a large margin, the central bank's credibility would be severely questioned. Having been burnt by the rate cut-for-lira devaluation swap of September 1992, many members of the CBC were not keen on appearing to bend so obviously to political pressure. Second, and most importantly, by lowering its discount rate to save the franc, the Bundesbank would be prolonging a continuous crisis that it believed could only be overcome by institutional changes within the EMS.

The Bundesbank chose a mix of the second and third options. It decided on July 29 to lower the Lombard rate from 8.25 percent to 7.75 percent but left the discount rate unchanged. Well aware that its decision would doom the deutsche mark–franc parity, the central bank had made the political gesture of cooperation by lowering the Lombard rate. Most importantly, the conser-

vatives within the Bundesbank could now use the crisis to try to force the widening of ERM bands that had been politically impossible earlier.

The Bundesbank's surprise decision to leave the discount rate unchanged did indeed lead to a severe crisis in the value of the franc.[50] The Banque de France was forced to sell $100 million worth of borrowed foreign exchange per minute to buy francs. At that pace the French central bank quickly ran out of the DM 30 billion in swap credit it had from the Bundesbank.

Chancellor Kohl and French Premier Balladur called for a secret meeting in Paris on July 30 to find a solution to the exchange rate crisis. The French delegation at the meeting, led by de Larosière, argued that the deutsche mark should be withdrawn from the ERM in order to save the exchange rate regime. Schlesinger, with the support of German Finance Minister Waigel, countered that that would put the blame for the crisis on the Germans and refused the step. Schlesinger again argued for a widening of the ERM bands to 6–8 percent and a suspension of intervention obligations. As neither side would agree to the other's arguments, the meeting ended in deadlock.

Following the Paris meeting, the Bundesbank and Finance Ministry were able to get Chancellor Kohl's agreement to their plan to push for a widening of the ERM bands at the EC Monetary Committee emergency meeting held in Brussels on July 31. At the meeting, the French delegation, which was still calling for the Germans to leave the ERM, found itself facing a coalition of the Germans with the Dutch, Belgians, and Danes which favored keeping the deutsche mark in the regime and widening the fluctuation bands.[51] On August 1, realizing that the coalition backing the Bundesbank was not going to agree to the deutsche mark's departure, the French delegation agreed to a widening of the exchange rate fluctuation bands to +/– 15 percent.[52]

The Bundesbank, which came under heavy fire in France for its role in the institutional transformation of the EMS, believed that it had saved the German political economy from a growing threat, as well as saved European monetary integration from a serious setback. As a senior Bundesbank official later put it: "It was the Bundesbank which attempted to save the EMS. We made the suggestions that kept it from totally collapsing. It is convenient for others to blame us."[53]

The news of the widening of the ERM bands was greeted with approval by most German organizations. The German Finance Ministry called the move "liberation" for the Bundesbank in a press conference after the decision. The transformation was also welcomed by industry, banking, and even labor organizations as a necessary step to alleviate the tension between German monetary policy and the EMS. The only notable German organization to decry the move was the DBV, the farmer's organization, which feared the effects of float-

ing exchange rates on the CAP. Thus the Bundesbank coalition had been able to achieve its desired institutional change without significant political cost.[54]

Despite the drama of the EMS's institutional transformation, it did not substantially affect exchange rate stability in the monetary regime. The Netherlands and Germany concluded, in a bilateral agreement, to keep their exchange rates within the old +/− 2.25 percent bands. The French government informally set itself to the goal of maintaining its old exchange rate parity with Germany as well. Because of the determination of the major EMS members to maintain exchange rate stability and their seeming determination to stick to the Maastricht route to monetary union, speculators backed away from attacking currencies as they had in 1992–93.[55] Thus as Europe moved toward the 1999 deadline for EMU, it enjoyed the same general exchange rate stability that had been the norm from 1987 until 1992.

Conclusion

The transformation of the EMS in the summer of 1993 is a salient example of international institutional change brought about because of the way international institutions affect the distribution of costs within a state. In this case, it was the changing nature of international currency markets and the domestic shock of German unification that were the catalysts for institutional change. As the EMS's rules raised the costs for German organizations interested in domestic price stability, which was made very clear in the September 1992 exchange rate crisis, the German central bank took the opportunity of a second major crisis to instigate institutional change to mitigate the costs of maintaining control of the domestic German monetary situation. The evidence demonstrates that the July–August transformation of the EMS was not unintended by the Bundesbank and its allies. The Bundesbank had made clear through statements, as well as its attempts to alter the EMS rules through political channels, that it believed a transformed EMS was necessary to protect its interests.

The evidence shows that the EMS transformation was not part of a plot hatched by the German state after the formulation of the Maastricht Treaty to scuttle the EMU process. In fact, the German Chancellory, Finance Ministry, and the Bundesbank all strived to save the EMS in the face of mounting costs. The Bundesbank made the devaluation for interest rate swap with the Italians in the hope of saving the lira in the ERM. It went to great efforts to maintain the franc–deutsche mark parity, including the swap credit to the French central bank, as well as huge intramarginal interventions to save the franc. The Bundesbank used monetary policy to force institutional change in the EMS in July 1993 not to scuttle EMU, but to free itself from the costs of intervening in

what other German organizations saw as an increasingly dangerous EMS. The apparent German policy change toward European monetary institutions came only after the 1992 monetary crisis and was never intended to be a change in German policy toward European Monetary Union.

The change in German policy from supporting the EMS status quo to pushing for EMS institutional change came from the way the EMS raised the costs associated with German unification and international capital market change. These changes led to a coalition of the Bundesbank, the Finance Ministry, banking, and industry organizations that supported widening the bands of the EMS to relieve the Bundesbank of intervention burdens. The coalition was based on these organizations' common interest in the Bundesbank's ability to control German price stability independently of international pressures.

The transformation of the EMS offers important lessons about the relationship between the institutions of the German political economy and European monetary institutions. The Bundesbank's willingness to provoke the practical suspension of the ERM clearly shows that the central bank believed it had the support of key state and private-sector actors that would enable the central bank to undertake such an effort without serious political repercussions. In the end, the German central bank was unwilling to trade the German monetary paradigm for an uninterrupted path of European monetary integration. As long as the major organizations of the German political economy continue to perceive gain from the Bundesbank's stability-oriented paradigm and make that clear, the German central bank will be bold enough to challenge those aspects of European integration which it thinks threaten its stability goals.

There is an important difference between this case and the other cases examined here; societal organizations were not as involved in the politics of this policy change as in the others. The reason for this was that all of the state organizations involved, the Bundesbank included, hesitated to draw societal organizations into the policy discussion of the issue, since it was considered by all of the state organizations as too sensitive for Germany's external image to make into a major policy flap. If such a debate had become open in Germany, it would have undermined Germany's neighbors' confidence in Germany's commitment to the monetary union process. That would have eroded confidence in the stability of currencies, only compounding the costs of the EMS to all of the German state organizations concerned with policy toward the regime.

This episode, like the others examined, shows just how important the institutions of policy making were to the dynamics of German policy change. The Bundesbank, as well as some industry and banking organizations, would have liked to have changed the institutions of the EMS immediately following the fall 1992 exchange rate crisis. But the Bundesbank did not have the unique

policy authority to change the German position on this issue. The Bundesbank would have to convince the Chancellory of the need for institutional changes, and that would take nearly a year to accomplish. But in the midst of the second EMS crisis, the German central bank was able to bring together a coalition with the Finance Ministry and the Chancellory that would in turn act as a catalyst to reshape the EMS.

7 Conclusion

This study was intended to explain why German policy toward European monetary institutions has been so dynamic. This required developing a framework for understanding the links between international institutions and domestic politics. This conclusion is the proper place to determine how far along this goal has come. To find that out, the following questions need to be answered: What have we found out about the relationship between international institutions and domestic politics? What has this study told us about the role the state plays in the German political economy, the influence of societal organizations, and the importance of the Bundesbank in shaping political outcomes in German politics? Finally what has this study contributed to our understanding of Germany's relationship to European monetary integration in the present transition period and the foreseeable future?

Unraveling the Puzzle: The Politics of Distributional Conflict

The question of how we can account for the puzzling dynamics in the German government's policy toward European monetary institutions from the late 1980s until the quasi-collapse of the EMS in the summer of 1993 has provided an opportunity for new thinking about the relationship between international and domestic politics. It was found that the international relations theories of international institutions, be it the European integration literature or the international regimes work, were not much help in answering the question of why German policy toward European monetary integration has been so dynamic. The main reason for their inability to provide answers stems from that literature's emphasis on the demand side of international institutional creation.

The international integration and regime theories are systemic, mainly functionalist explanations of why international institutions are created. But, as this study has shown, functionalist theories suffer from a central fault that constrains their usefulness: they are largely apolitical. According to their function-

alist logic, the systemic conditions that make institutions necessary are almost always present. Yet we see that international institutions are difficult to create or sustain, and states may change their positions on institutions over time. In order to understand the dynamics of state choice toward international institutions, we need to understand how international institutions matter to those who affect those choices, and that means delving into the relationship between international institutional choice and states' domestic politics.

This study has exposed in detail the tight relationship between international institutions and domestic politics, which has become an important focus in international political economy (Haggard and Simmons 1987; Simmons 1993; Sobel 1994). It has shown that international institutions matter to political actors as a consequence of the way they affect the distribution of costs and benefits within polities. International institutions matter because they affect the gains from trade and they constrain the international as well as domestic policy choices state actors may make. These effects are differentiated across actors within polities, leading to domestic political conflict between those who gain and those who lose. As organizations perceive that there is power through cooperation by pooling their resources, they form coalitions to shape state actors' positions on international institutional choice. Therefore, state positions on international institutional choice are molded by those domestic political coalitions with the greatest political power. Changes in state positions on international institutional choice over time are caused by changes in the costs to state and societal organizations of adhering to those institutions. Obviously those who stand to lose from these factors will have an incentive to change institutions to fit their needs.

The four cases dealing with the German relationship with European monetary institutions bear out these ideas. We can see that various German state and nonstate organizations had different expectations of the costs and gains from European monetary institutional initiatives based on what they could do to public policies and the gains from trade. The coalitional politics that was generated by these expectations of loss and gain shaped the German state's positions on European monetary institutional change.

The politics in Germany surrounding the EMS were shaped by considerations of what organizations stood to gain or lose from the creation of a European monetary regime. Schmidt proposed the regime in order to restart European integration and protect Germany from the negative effects of American monetary policy. Schmidt was able to gather a coalition of industry and banking organizations to support the principle of the EMS, as they stood to gain from stable exchange rates, but he was not able to get this coalition to support his particular vision of the institutions of the new regime. Because the

Bundesbank was able to get a coalition of banking and industry organizations to support its and not Schmidt's plan for the institutions of the EMS, Schmidt had to change his policy toward the institutional design of the regime.

In the case of the Franco-German Economic and Finance Council, the Bundesbank and its coalition of banking and industry organizations suspected that the Bundesbank's policy autonomy would be constrained by the proposed institutions; that is why they opposed the initiative. Because that coalition was strong enough to shape the German government's position on the council, the council was stripped of its significance.

The EMU initiative generated even more domestic conflict, in that the stakes involved were much higher. Initially, the Bundesbank was able to rally a large and powerful enough coalition to keep the German government from committing to the EMU design process. Changes in the international environment, namely the shadow of German unification, changed the domestic German EMU conflict and, in turn, the German position on EMU. The potential of German unification changed the costs and gains for most German organizations of agreeing to EMU. With rapid German unity only achievable by German consent to the EMU design process, most organizations backed acquiescence to EMU to secure the expected economic and political gains to be made from unification. But once unification was politically secured, the Bundesbank was able to draw together a formidable coalition to shape the German position on EMU design. That coalition had little impact on the Maastricht negotiations, where German negotiators were free to make deals according to their own preferences.

It was also changes in the international and domestic environment, this time international financial liberalization and the consequences of German unification, that caused the Bundesbank to change its position on the EMS and bring about its institutional transformation. The Bundesbank expected that the effects those changes had on the Bundesbank's goal of German price stability would only intensify if the EMS were to persist in its original form. The costs associated with this situation prompted the Bundesbank to strive for EMS institutional change in order to lower its cost of maintaining a stability-oriented monetary policy.

Thus the key to the puzzle of why the German government altered its policy on European monetary institutions lies in the expected distributional consequences of those institutions to state and societal organizations in Germany. By accounting for distributional aspects of institutional change, we gain a more complete picture of the mechanisms and dynamics of institutional choice.

Clearly, more work must be done on developing models and frameworks that clarify the relationship between domestic politics and international institutions. This model has been devoted to only one aspect of the relationship:

why a state may change its position on international institutional choice over time. But, as was detailed here, international institutions can profoundly affect many aspects of domestic politics. As the world witnesses the creation of more international institutions, be they in the new World Trade Organization, NAFTA, or the efforts in Western Europe, the need for understanding how they impact on politics within polities will grow more apparent. Likewise, as international institutions become more salient, we will want to know how their creation or destruction is affected by relevant states; that means understanding how domestic politics affects state positions on those institutions. This is fertile ground for further research on the nexus between the international and domestic realms of politics.

The Role of Domestic Political Institutions

The institutions of the German policy process concerning international monetary institutions were a key factor in the dynamics of that policy. The findings of this study add weight to those who argue that institutions can be crucial to political outcomes (Knight 1992; North 1990; Steinmo, Thelen, and Longstreth 1992). The two most important institutional attributes of the policy area were the large number of state decision makers involved in the policy area and the role of interest organizations in the policy-making process. Together, these institutions shaped the scope of politics surrounding European monetary institutional issues.

The effect of a large number of state actors involved in policy toward international monetary institutions was clearly evident in all four cases examined. The policy battles involving the Bundesbank, Finance Ministry, Foreign Office, and Chancellory contributed to the discontinuities in German policy because each of these state organizations had an independent say in a part of the policy toward international monetary institutions. This meant that it often appeared that Germany had several policies at once. But because no single organization had a dominant say over the others, if they could muster a strong enough coalition they could change the official German position.

The constraining role afforded societal organizations by the institutions of policy making in this area was another key factor in the dynamics of German policy. Because societal organizations had substantial political power at their disposal, and they were sought out as partners for policy coalitions by state organizations, they were pivotal actors in all four cases. If the Bundesbank had wanted to change Schmidt's position on the design of the EMS and it had not had the support of the major banking and industry organizations, Schmidt would not likely have been able to get his way. Likewise, Kohl had to back away

from his original plan for the Franco-German Economic and Finance Council because of interest organizations weighing in on the side of the Bundesbank. The changed position of interest organizations on EMU because of German unification allowed Kohl to pursue the EMU initiative. And it was the support of interest organizations in Germany for changes in the EMS which gave the Bundesbank the backing it thought it needed to push for institutional changes in the EMS.

These institutional factors made for several embarrassing moments for German chancellors and foreign ministers in dealing with their European counterparts. Chancellors had to back away from positions they wanted to maintain and had to face the ire of their European partners for doing so. The institutional structure of German policy toward international monetary institutions made that policy anything but a straightforward affair.

The German Political Economy

Aside from providing answers about the relationship between Germany and European monetary institutional change, this study has provided some very important lessons about the nature of the German political economy. The most important lessons concern the nature of the German state, the importance of societal organizations to political outcomes, and the special role of the Bundesbank in German policy making.

German state actors played key roles in the political outcomes dealt with in this study. The Chancellory, the Foreign Office, the Finance Ministry, and the Bundesbank were all crucial to shaping German policy toward European monetary institutions. But contrary to the common state-centric studies of German policy and politics, this study has emphasized that these organizations do not operate in a political vacuum. They depend to a great extent on the support of societal organizations to achieve their various political goals. This work has shown that models of German policy that treat state organizations as autonomous actors are misleading.

State-centric explanations of political outcomes can provide only a part of the answer, and in many cases not the most important part. As we saw in all the conflicts within Germany over European monetary institutional issues, state actors coalesced with societal organizations in order to achieve their desired outcomes. This study has added a great deal of credence to Katzenstein's (1987, xxiii) assertion that "the power of German state officials is both severely circumscribed and widely diffused."

This study has also revealed the faults of Marxist accounts of the relationship between the German state and policy. The Marxist assertion that the

German state is merely the superstructure of German capitalism was clearly refuted by several instances of direct and acrimonious conflict between German industry and banking organizations and state organizations. The issue of the Franco-German Economic and Finance Council and the negotiations over EMU are salient examples wherein the German government conflicted with major organizations of German capitalism. The fluidity of German domestic political coalitions debunks the Marxist view of a monolithic and static state-capital coalition seeking to maximize German capitalism's profits. The Marxist model also fails us in its depiction of the German state as a unified organization. Conflicts between state organizations in Germany were a crucial part of the dynamics of the German relationship to European monetary institutions.

The Bundesbank played a central role in the outcomes dealt with in this study. An intended contribution of this work was to help delineate the boundaries of Bundesbank autonomy in the German political economy. State-centric studies of German monetary issues have always been unable to sufficiently explain why the Bundesbank has variable success in domestic political conflicts because they ignore many of the sources of Bundesbank power.

This work has shown that the Bundesbank does not have a unit veto power in German monetary issues; it depends on the support of state and societal political allies to win in political conflicts. When it cannot garner the political support it needs, the central bank is forced to concede.

Overall, the Bundesbank has been able to avoid all serious challenges to its autonomy through support from the Finance Ministry and industry and banking organizations. As one DGB functionary puts it: "You cannot tame the Bundesbank with mechanical methods, with narrow ERM bands or a Franco-German Economic and Finance Council. It will only work when politicians and entrepreneurs want it."[1]

As it is not foreseeable that German banking and industry organizations, or the Finance Ministry, will want to replace the Bundesbank monetary paradigm any time soon, the Bundesbank's autonomy seems relatively safe. But the German central bank will have to continue to encourage and seek the support of those German state and societal organizations that are so crucial to its political power. So while the Bundesbank remains safe, it also remains constrained. We need to do more to systematically study the behavior of the Bundesbank to better understand how political pressure and support matter to the central bank. The important role that societal organizations play in constraining the power of German state organizations points to the need to increase our attention to the nonstate sector of German society. But we must be aware of several important points. Above all, we should not overemphasize the role of German societal organizations in political outcomes, lest we fall into the trap of pluralist

models' conception of the state as a disinterested black box that merely outputs societal organizations' desires (see Steinmo, Thelen, and Longstreth 1992). Societal organizations in Germany are important political actors in conjunction with state actors. They do not run the political show in Germany on their own.

We must also be aware that getting a clear picture of the role that societal organizations play in German policy making is difficult. A great deal of German societal organizations' political behavior we see is constrained and channeled by informal institutions. Also, a large part of the political process of bargaining between state and nonstate organizations is not formalized, but goes on through venues not yet fully explored. Although this research was a concerted effort to uncover a part of the political process that was previously ignored, much more needs to be done before we can begin to fully understand the role of societal organizations in the German political economy.

Germany and European Monetary Integration: The Consequences of Discontinuity

European monetary institutions have been greatly affected by German positions in interstate negotiations. The economic and political power of Germany, plus the German ability to line up coalitions of like-minded governments in acrimonious bargaining situations, have given European monetary institutions a distinctly German flavor. As we saw, the EMS, the Franco-German Economic and Finance Council, and the plan for EMU all reflect German institutional positions to a great degree.

This study has shown that German policy toward European monetary institutions has been dynamic. We know from other studies of European monetary politics that Germany's role in shaping European monetary institutions has been great. So what consequences, negative or positive, can we attribute to German policy discontinuity?

Three points need to be made. First, the discontinuity in German policy matters a great deal to financial markets. Germany, being the most economically and monetarily powerful state in Europe, has a great effect on the entire European political economy. Part of this power comes from the sheer size of the German market, but part of it developed through the institutions of the EU. When the Germans create their monetary and economic policies it has ramifications for all the markets of the EU. If German policy is characterized by frequent changes, then it is difficult for economic players to bet on the future. If the market signals from the German government change rapidly, it may indeed impede investment. One could surmise that investors will take a "let's wait and see" attitude. The uncertainty over the future of EMU because of re-

cent German policy changes is good evidence of this effect. Banks are not sure what to do about getting ready for EMU because of the uncertainty of its future. This could leave European banks in a very precarious position.

The second major consequence of German policy discontinuity is that it makes it difficult for other European states to negotiate with the German government. As the four cases examined here show, the French government had to face frequent and important changes in German policy during the course of negotiating the shape of European monetary institutions. Having a negotiating partner that changes positions frequently makes it difficult to develop a bargaining strategy. This raised the level of tension in negotiations more than once due to French impatience with Germany's changing position.

Finally, because Germany sits at the proverbial center of European monetary affairs, its frequently changing policies have contributed to the see-saw nature of European monetary integration. The trajectory of European monetary integration has been anything but a unilinear, uninterrupted path. Part of the problem with achieving a straight path to monetary integration has come from international economic and monetary shocks. But a large part of it comes from the fact that the most important actor in the European monetary drama sometimes has seemed rather fickle.

Notes

1 Introduction

1 The emphasis has been added by the author.
2 North refers to these changes in the environment as relative price changes.
3 This does not preclude the possibility that state actors could all have the same interests concerning a policy issue. But this is unlikely because of the different areas of responsibility of state organizations.
4 Chapter 2 will provide an overview of the actors, interest, and institutions of German monetary-regime policy making.
5 The information for the countries other than Germany came from Caesar (1981), Goodman (1992), Henning (1994).

2 The German Monetary Paradigm: Actors, Interests, and Institutions

1 Quoted in *Business Week*, 23 August 1993.
2 Interview with senior Bundesbank official.
3 An important exception to this was the political conflict over the restructuring of the Bundesbank following unification. The Bundesbank had previously maintained one central bank per Land, but with the increase in the number of Länder from eleven to sixteen, many felt the Bundesbank would become too cumbersome. The issue was taken up in the Bundesrat since many Germans saw it as an issue of Länder rights.
4 A prominent example of conflict between the chancellor and the minister of finance was the battle between Helmut Schmidt and Hans Apel over the 1978 plan to create the EMS. Apel sided with the Bundesbank, industry, and banking organizations in expressing his reservations about the inflationary potential of the regime.
5 Interview with Ministry of Finance official.
6 Before 1992, the Land central banks were arranged on the federal principle of one Land, one Land central bank. But as a result of unification and the resulting increase in the number of Länder from eleven to sixteen, the CDU/CSU-FDP government initiated a restructuring of the Bundesbank to streamline the CBC. The restructuring of the Bundesbank entailed creating regional central banks in place of some of the old Land central banks. See Marsh (1992) for an account of the change.
7 Until the restructuring of the Bundesbank in 1992, there were eleven LCBS.
8 The Bundesbank controls the interest rates for security repurchase agreements and is also responsible for banks' minimum reserve requirements. The central bank also engages in open market transactions, that is, the buying and selling of securities to regulate the money market.
9 The Basic Law only mentions in Article 88 that a federal central bank should be established; no mention is made of the bank's duties or independence from the government.

10 The idea for monetary targeting came from Helmut Schlesinger, a staff economist at the Bundesbank who went on to become president of the central bank in 1991. The idea behind monetary targeting came from the oil crisis period when the Bundesbank believed that it needed to move from "moral suasion" to convince the "social partners" to moderate wage demands to setting down clearly stated parameters of monetary conditions.

11 Goodman's (1992) treatment of German monetary policy from 1973 to 1986 is replete with examples of how the Bundesbank used its monetary policy to send signals to state and nonstate organizations about its policy preferences.

12 Interview with BDI functionary.

13 The BDI has a sister organization, the Bundesvereinigung der Deutschen Arbeitgeberverbände (BDA), the Federation of German Employers' Associations. This organization coordinates the collective bargaining strategy of German employers and deals with questions of social policy. This study does not deal with the BDA, which leaves general economic and monetary matters to the BDI.

14 Interview with BDI functionary.

15 Ibid.

16 Ibid.

17 Interviews with DIHT functionaries.

18 Interview with BDB functionary.

19 Interview with DSGV functionary.

20 Ibid.

21 Interview with senior GSDS functionary.

22 Ibid.

23 Other peak associations for labor exist, such as the Christian Trade Union, but they play a relatively inconsequential role in the German political economy (Markovits 1986).

24 The most important of the DGB's member unions is the metal workers' union, IG Metall. This union, which is the largest of any union in the industrialized democracies, with about 2.5 million members, sets the tone of collective bargaining in the Federal Republic.

25 The strike in the metal working sector in 1984 led by IG Metall, the largest and most powerful of Germany's unions, was considered a success and a clear indication of the union's power when it was able to force business and the CDU/CSU-FDP government to accept the thirty-five-hour work week.

26 Interview with senior DGB functionary.

27 Ibid.

28 Ibid.

29 That membership is increasing as many new members join from the former GDR. In fact, the substantial farm sector of the GDR has bolstered not only the numbers but also the power of the DBV after unification.

30 Interview with DBV functionary.

31 Ibid.

32 Ibid.

33 Even when the SPD dominated the government coalition from 1969 to 1982, the DBV was able to secure its interests by having a pro-agriculture FDP member given the agriculture portfolio.

34 Interview with CDU functionary.

35 The euro is the planned name for the common currency of the European Monetary Union.

3 German Domestic Politics and the Development of the European Monetary System

1 The 1957 treaty called for the creation of a monetary committee to help coordinate member states' economic and monetary policies. As there was strong disagreement among the EC members on what types of policies to choose, the committee had very little impact.

2 The famous statement by De Gaulle's minister of finance, Jacques Rueff, "If Europe is to be made, it will be made through money," sums up the thinking of those who felt that monetary integration would foster greater political integration, the end goal being European political union.

3 The snake in the tunnel consisted of the EC member states, plus Britain, Ireland, Norway, and Sweden.

4 The "Snake" grew smaller during the course of the 1970s, with Sweden withdrawing in 1977 and Norway in 1978. The system was not officially replaced until the implementation of the EMS in March of 1979.

5 The European displeasure with the lack of American leadership centered on the perceived benign neglect of the dollar, the pressure on the Germans to reflate in order to bolster the international economy, and disagreements over policy toward the Soviet Union.

6 *Business Week*, 26 June 1978.

7 Katzenstein (1987, 95) also makes the argument that Schmidt hoped to use the EMS to force the Bundesbank to reflate the German economy. This view was also expressed to the author in an interview with a senior DGB functionary. He stated: "Schmidt had in mind controlling the Bundesbank with the EMS. We saw that as a possible bonus as well." But there is no evidence to support that this was Schmidt's intention, and this goal was never publicly articulated by Schmidt or any of his cabinet members.

8 *Business Week*, 26 June 1978.

9 The EAU, the European Accounting Unit, was a monetary unit based on the weighted average of all of the "snake" currencies. It was simply used as a means for accounting and was not the actual anchor of the "snake" system.

10 Interview with DBV functionary.

11 Interview with senior DGB functionary.

12 *Frankfurter Allgemeine Zeitung*, 13 July 1978; interview with senior Bundesbank official.

13 *Frankfurter Allgemeine Zeitung*, 7 July 1978; *Handelsblatt*, 6 December 1978.

14 Interview with senior Ministry of Finance official.

15 Interview with BDI functionary.

16 Interview with BDI senior functionary; interview with DIHT functionaries.

17 BDI, "Economic and Monetary Union: A Challenge for Europe," January 1990, p. 15.

18 The BDB gave the proposal its general support but was adamant that the EMS be designed in a way that would ensure that the Bundesbank standard of monetary discipline would prevail. See Harald Kühnen (president of the BDB), "Eine Chance für Europa: Wie die Banken das EWS sehen," *Frankfurter Allgemeine Zeitung*, 12 September 1979.

19 Interview with senior DSGV functionary.

20 The news of the secret negotiations came out in an *Economist* article on 26 May 1978. This was the first time anyone in the Bundesbank had heard of any such negotiations. See Ludlow (1982, 95) for a discussion of the episode.

21 Interview with senior Bundesbank official.

22 *Frankfurter Allgemeine Zeitung*, 4 July 1978.

23 *Frankfurter Allgemeine Zeitung,* 5 July 1978. Schmidt also faced considerable pressure from the opposition CDU/CSU. Franz-Josef Strauss, leader of the CSU, warned Schmidt that he should not make any agreements in Bremen that would bind the Bundesbank to a monetary regime.
24 *Frankfurter Allgemeine Zeitung,* 4 July 1978; *Frankfurter Allgemeine Zeitung,* 6 July 1978.
25 *Frankfurter Allgemeine Zeitung,* 7 July 1978. See Ludlow (1982, 301–2) for details of the five points of the Bremen Communiqué.
26 *Frankfurter Allgemeine Zeitung,* 7 July 1978.
27 *Frankfurter Allgemeine Zeitung,* 13 July 1978.
28 *Frankfurter Allgemeine Zeitung,* 15 July 1978.
29 See Goodman (1992, 194) for a succinct explanation of how the various funds work.
30 *Frankfurter Allgemeine Zeitung,* 14 September 1978.
31 The "Belgian Compromise" included the use of a divergence indicator, which meant that currencies which diverged in either direction from the central rate would have to intervene. It also called for the future use of the ECU as the cornerstone of the system. Neither part of the compromise came to fruition.

4 Challenging Bundesbank Dominance: The Franco-German Economic and Finance Council Initiative

1 See Kruse (1982) and Wu (1981) concerning the conflict over EC agricultural programs and the EMS.
2 Otmar Emminger, the Bundesbank president in 1979, feared that if the deutsche mark became a reserve currency it would lead to speculative inflows from the dollar to the deutsche mark. See *Frankfurter Allgemeine Zeitung,* 27 September 1979.
3 Scholars who have focused on the Bundesbank in the EMS have argued that a clear indication of Bundesbank dominance in the EMS is the way in which interest rates are set in the EMS. Smeets (1990) examines the manner in which interest rates are determined to answer the question of whether or not it is correct to refer to the EMS as a "deutsche mark zone." He concludes that the Bundesbank sets the interest rates for Germany, which then in turn are reacted to by the other members of the EMS.
4 Whereas Germany saw its unemployment rate drop in 1983 from 6.6 percent to 6.4 percent by 1986, France and Italy in the same time period saw their unemployment rates rise from 8.4 percent to 10.4 percent and from 10.1 percent to 11.2 percent respectively.
5 Econometric evidence supported the French and Italian as well as some Germans' fears that the Bundesbank-dominated EMS was stifling economic growth in the EC. De Grauwe (1987) compared the EMS member states and non-EMS states to determine whether there was evidence of a deflationary bias in the EMS. He found that the EMS members stand out as a group of countries which experienced a substantial slowdown in economic growth in the 1980s. It was also found that there was a substantial decline in investment in the EMS compared to the rest of the industrialized world. Another very disturbing result is that intra-EMS trade flows actually decreased in the eighties. But others could point to the benefits of the EMS. They point out that the volatility of intra-EMS exchange rates has declined significantly since 1979. They also find that the inflation rates of EMS members have declined sharply since 1979 and have become more convergent, although studies have shown that EMS member inflation rates did not decline more sharply on the average than non-EMS states (De Grauwe 1987; Rogoff 1985; Collins 1988).
6 Quoted in *Die Zeit,* 9 October 1987.

7 *Neue Züricher Zeitung,* 10 September 1987; *Frankfurter Allgemeine Zeitung,* 9 September 1987; *Handelsblatt,* 10 September 1987; *Frankfurter Allgemeine Zeitung,* 12 September 1987.

8 *Neue Züricher Zeitung,* 13 September 1987.

9 The meeting had split along the lines of a coalition of the weak-currency countries, that is, France, Italy, and Belgium, and a coalition of the hard-currency countries, Germany, the Netherlands, and Denmark. The weak-currency coalition argued for automatic intervention rules for the hard-currency central banks and generous financing terms for their own interventions. The hard-currency coalition called for minor changes in the financing facilities available to central banks in order to make it easier for weak-currency countries to bear the burden of adjustment.

10 *Handelsblatt,* 14 September 1987; "Bericht des Auschusses der Zentralbankpräsidenten über die Stärkung des EWS," Auschuss der Präsidenten der Zentralbanken der Mitgliedstaaten der Europäischen Wirtschaftsgemeinschaft, 10 September 1987.

11 "EG Finanzminister stärken gemeinsame Währungspolitik," Deutsche Pressagentur press release, 13 September 1987.

12 The reaction of Germany's banking and industry organizations to the agreement was negative, as those organizations feared the changes in financing rules could potentially cause the Bundesbank to lose control of the domestic German money supply. "Banken: begrenzte Weiterentwicklung der EWS Regeln," Bundesverband Deutscher Banken, Pressedienst, 14 September 1987; interview with a senior DSGV functionary; *Handelsblatt,* 18 September 1987; Werner Steuer, "Die geldpolitischen Risiken der neuen EWS-Regeln," *Frankfurter Allgemeine Zeitung,* 17 October 1987; DIHT Bericht 1987, p. 87; interview with senior BDI functionary.

13 "EG Finanzminister stärken gemeinsame Währungspolitik," Deutsche Presseagentur press release, 13 September 1987, p. 2.

14 *Neue Züricher Zeitung,* 15 September 1987; *Die Welt,* 14 September 1987; *Handelsblatt,* 15 September 1987.

15 Interview with Foreign Office official.

16 *Financial Times,* 25 January 1988.

17 *Bulletin der Bundesregierung der Bundesrepublik Deutschland,* 27 January 1988.

18 *Frankfurter Allgemeine Zeitung,* 27 January 1988.

19 *Frankfurter Allgemeine Zeitung,* 23 January 1988.

20 BDI internal memo, 2 February 1988. The same argument was conveyed in an interview with a senior BDI functionary.

21 Interviews with DIHT functionaries.

22 "Bundesregierung: Autonomie der Bundesbank steht nicht in Frage," Deutsche Presseagentur press release, 22 January 1988.

23 Interview with senior DGB functionary.

24 Interview with senior DBV functionary.

25 *Handelsblatt,* 6 September 1988.

26 *Handelsblatt,* 22 July 1988.

27 Ibid.

28 *Frankfurter Allgemeine Zeitung,* 22 March 1988.

29 *Handelsblatt,* 23 March 1988.

30 *Süddeutsche Zeitung,* 1 June 1988.

31 *Handelsblatt,* 19 September 1988; *Financial Times,* 16 September 1988; *Frankfurter Allgemeine Zeitung,* 17 September 1988.

32 *Frankfurter Allgemeine Zeitung,* 13 October 1988; *Frankfurter Allgemeine Zeitung,* 11 Novem-

ber 1988; "Gesetz zu den Protokollen vom 22 Januar 1988 zum Vertrag vom 22 Januar 1963 zwischen der Bundesrepublik und der Französischer Republik über die deutsch-französische Zusammenarbeit," Bundestag, Drucksache 576/88, 2 December 1988.

5 The Ties That Bind: German Policy Toward European Monetary Union

1 *Handelsblatt*, 2 July 1987; *Die Welt*, 19 October 1987.
2 *Frankfurter Allgemeine Zeitung*, 27 June 1987
3 *Financial Times*, 11 January 1988; *Frankfurter Allgemeine Zeitung*, 13 January 1988; *Die Welt*, 18 January 1988; *Frankfurter Allgemeine Zeitung*, 21 January 1988; *Financial Times*, 22 January 1988.
4 Interview with CDU functionary. See also Kohl (1990).
5 Interview with senior Foreign Office official.
6 *Handelsblatt*, 21 January 1988.
7 Hans-Dietrich Genscher, "Memorandum für die Schaffung eines Europäischen Währungsraumes und einer Europäischen Zentralbank," 26 February 1988.
8 *Handelsblatt*, 6 May 1988.
9 The Bundesbank was quick to point out that Genscher's memo was made in his capacity as head of the FDP and was not the official position of the German government. *Frankfurter Allgemeine Zeitung*, 11 March 1988.
10 *Frankfurter Allgemeine Zeitung*, 4 March 1988.
11 *Frankfurter Allgemeine Zeitung*, 31 January 1989. According to a poll carried out by the respected Allensbach Institute in 1988, only 20 percent of Germans favored replacing the deutsche mark with a single European currency. A majority of 57 percent opposed giving up the deutsche mark. Interestingly, in the mid-1970s, the figures were reversed, with 57 percent in favor of a single currency and only 22 percent against.
12 *Handelsblatt*, 24 February 1988; *Frankfurter Allgemeine Zeitung*, 1 March 1988; *Süddeutsche Zeitung*, 2 March 1988.
13 *Handelsblatt*, 9 February 1988.
14 *Frankfurter Rundschau*, 16 March 1988.
15 Gerhard Stoltenberg, "Zur weiteren Entwicklung der währungspolitischen Zusammenarbeit in Europa," Memorandum des Bundesfinanzministers, 18 March 1988; *Frankfurter Allgemeine Zeitung*, 18 March 1988.
16 *Frankfurter Allgemeine Zeitung*, 7 April 1988.
17 See "Diskussionspapier zur Wirtschafts- und Währungsunion aus der Sicht des Deutschen Gewerkschaftsbundes," DGB, Abteilung Strukturpolitik, 16 January 1990.
18 Interview with DGB functionary.
19 Interview with senior DBV functionary.
20 *Süddeutsche Zeitung*, 8 February 1988; *Handelsblatt*, 22 February 1988.
21 Interview with DIHT functionary.
22 "Faits et Opinions: European Business and the ECU," a survey carried out among 1,036 business leaders in the European Community, European Commission, Brussels, 25 October 1988. The EC average acceptance for the EMU idea among industrialists was 90 percent.
23 *Frankfurter Allgemeine Zeitung*, 20 June 1988; "Preisstabilität nicht der Währungsintegration opfern," BDI *Informationen und Meinungen*, March 1989.
24 "Strategien der Banken," *Commerzbank Wirtschaftsnotizen*, March 1988; *Frankfurter Allge-*

meine Zeitung, 4 November 1988. See Remsberger (1991) and Lipp and Reichert (1991) for considerations of EMU from the perspective of German bankers.

25 *Frankfurter Allgemeine Zeitung*, 16 March 1988; *Süddeutsche Zeitung*, 16 March 1988; *Jahresbericht der Bundesverband der Deutschen Banken*, 1989.

26 *Handelsblatt*, 12 March 1988; *Frankfurter Allgemeine Zeitung*, 31 January 1989.

27 Karl Otto Pöhl, "A European Central Bank and a European Currency Could Be the Crowning Achievement of the Long and Difficult Process to Monetary Union in Europe," World Link, Geneva, April 1988. Published in Deutsche Bundesbank, *Auszüge aus Presseartikeln*, 7 April 1988, p. 2.

28 *Frankfurter Allgemeine Zeitung*, 6 June 1988; *Kölner Stadt Anzeiger*, 6 May 1988.

29 The members of the "Delors Committee" included the central bank governors of all the EC central banks plus other monetary experts. All of the members of the Delors Committee officially acted as private individuals and did not represent their state organizations.

30 *Frankfurter Allgemeine Zeitung*, 17 November 1988.

31 The report represented a victory for the "economists" in the committee. It envisioned EMU and the creation of an EC central bank as end products of a three-step process. The first step, to take place on 1 July 1990, was to liberalize EC capital markets and to bring the rest of the EC currencies into the ERM. The second step, which had no date assigned and demanded a revision of the Treaty of Rome, called for the creation of a European system of central banks, which was to be an embryonic EC central bank. The second stage would also have narrower bands in the ERM and an increased coordination of monetary policies. The third stage would see the creation of a single currency and an EC central bank to manage it. The report called for that central bank to be federally structured and independent of government instruction and committed to monetary stability.

32 See "Der Delors Bericht-ein brauchbarer Fahrplan für ein Europäisches Wähungsystem," SPD Pressedienst, *Wirtschaft*, 23 May 1989; *Handelsblatt*, 3 May 1989; *Handelsblatt*, 13 April 1989.

33 *Frankfurter Allgemeine Zeitung*, 22 June 1989.

34 *Handelsblatt*, 29 June 1989; *Handelsblatt*, 4 July 1989.

35 *Herald Tribune*, 13 November 1989.

36 *Stuttgarter Zeitung*, 7 December 1989; *Handelsblatt*, 7 December 1989.

37 "Auszug aus der Erklärung von Bundeskanzler Kohl vor dem Bundestag, Bonn, am 28. November 1989," *Auszüge aus Presseartikeln*, Deutsche Bundesbank, 1 December 1989.

38 *Süddeutsche Zeitung*, 11 December 1989.

39 *Frankfurter Allgemeine Zeitung*, 8 December 1989.

40 In order to speed up the process of laying the foundation for German unification, Kohl offered a ten-point program in late November 1989 that proclaimed his determination to make unification his top political priority. See "Das Zehn-Punkte-Programm zur Überwindung der Teilung Deutschlands und Europas vom 28. November 1989," in Kohl (1990).

41 *Frankfurter Allgemeine Zeitung*, 7 December 1989.

42 Interviews with DIHT, BDI, and BDB functionaries.

43 *Handelsblatt*, 12 December 1989.

44 Interview with senior Foreign Office official.

45 *Handelsblatt*, 11 December 1989.

46 See, for example, *Handelsblatt*, 24 January 1990; *Handelsblatt*, 27 January 1990.

47 A salient example of the Bundesbank's inability to call the shots on unification was the issue of monetary union between the two German states. In mid-March 1990 Kohl announced that

the conversion rate between the two German currencies would be one-to-one for an unspecified amount. The Bundesbank saw this as a definite threat to price stability and tried to set the rate at 2 to 1. But no major organization would side with the Bundesbank, as its position was considered politically infeasible. See *Frankfurter Allgemeine Zeitung,* 21 April 1990. See also Henning (1994) for a thorough discussion of the issue.

48 "Bundesbank-Stellungnahme zur EWWU," *VWD-Europa,* 24 September 1990. The formal publication of the Bundesbank plan came in the October 1990 issue of the *Bundesbank Monthly Report,* pp. 40–44.

49 See, for example, *Frankfurter Allgemeine Zeitung,* 16 October 1990; *Süddeutsche Zeitung,* 19 December 1990; "Stellungnahme des Deutschen Sparkassen- und Giroverbandes zur Schaffung einer Europäischen Wirtschafts- und Währungsunion," DSGV memo, December 1990.

50 Interview with senior Finance Ministry official. Although the Bundesbank had some influence in the EMU debate through its leadership of the committee of central bank governors, it depended foremost on the Finance Ministry (the chief German negotiator at EMU design summits) to forward its position; interview with senior DSGV functionary.

51 "Geuenich: Wirtschafts- und Währungsunion vorantreiben," DGB *Nachrichtendienst,* 5 October 1990.

52 More surprisingly, the French government also accepted the *general* premises of the Bundesbank plan.

53 *Süddeutsche Zeitung,* 24 March 1990; *Süddeutsche Zeitung,* 2 April 1990; *Handelsblatt,* 3 April 1990.

54 *General Anzeiger,* 24 March 1990. At a special EC summit concerning Germany unification held in Dublin in June 1990, Kohl was able to successfully press the political union to a top spot on the EC agenda. The summit agreed to have two IGCs, one on monetary union, the other on political union. *Neue Züricher Zeitung,* 2 May 1990; *Handelsblatt,* 26 June 1990.

55 *Frankfurter Allgemeine Zeitung,* 18 September 1990.

56 *Neue Züricher Zeitung,* 8 December 1990; *Frankfurter Allgemeine Zeitung,* 30 January 1991.

57 *Financial Times,* 6 August 1991.

58 The Maastricht summit was decisive because it was the meeting of EC government leaders and finance ministers that was to produce the final treaty text for the EMU project. *Frankfurter Allgemeine Zeitung,* 6 March 1991; *Frankfurter Allgemeine Zeitung,* 10 September 1991; *Die Welt,* 11 September 1991; *Frankfurter Allgemeine Zeitung,* 28 September 1991.

59 "Banken: konsistente Wirtschafts- und Finanzpolitik erforderlich," *Bundesverband Deutscher Banken Pressedienst,* 11 December 1991.

60 *Süddeutsche Zeitung,* 19 September 1991; *Frankfurter Allgemeine Zeitung,* 19 September 1991; *Frankfurter Allgemeine Zeitung,* 15 October 1991; *Handelsblatt,* 12 June 1991.

61 *Handelsblatt,* 2 October 1991; "Eckpunkte zur Europäischen Wirtschafts-und Währungsunion," DGB *Informationen zur Wirtschafts- und Strukturpolitik,* 26 August 1991.

62 *Frankfurter Allgemeine Zeitung,* 10 December 1991.

63 *Treaty on European Union,* Luxembourg: Office for Official Publications of the European Communities, 1992.

64 Interview with senior Foreign Office official.

65 Ibid.

66 See *Frankfurter Allgemeine Zeitung,* 11 December 1991; *Die Zeit,* 13 December 1991; BDI, "Keine guten Vorbedingungen für den Erfolg einer Währungsunion," 12 December 1991.

67 Institutional improvements included the treaty's detailed descriptions of the scope and limits

of the European Central Bank's (ECB) duties and independence. It was very clearly stated in the treaty that the ECB would be committed above all else to price stability. The treaty also stipulated EC politicians would be limited to providing the central bank only "general orientations," unlike the Bundesbank's duty to support the government's economic policy.

68 "The Maastricht Decisions on the European Economic and Monetary Union," *Monthly Report of the Deutsche Bundesbank,* February 1992; *Süddeutsche Zeitung,* 8 February 1992. For the BDI position see "BDI zum Vertrag zur Wirtschafts- und Währungsunion," BDI memo, 20 February 1992; for the DIHT position see *Frankfurter Rundschau,* 20 February 1992; for the position of the savings banks see *Handelsblatt,* 6 February 1992.

69 *Börsen-Zeitung,* 3 December 1992.

70 This was not an unlikely scenario. German industry had already shown a tendency to move operations overseas for production cost reasons. By 1995 German firms were investing more overseas than they were in production in Germany. Doubts about European monetary arrangements would only accelerate Germany's capital flight.

71 Following the signing of the Maastricht Treaty, German industry and banking interest organizations launched an effort to use the German press to focus attention on the government's policy toward EMU. The intention was to get the public interested in EMU so that the Kohl government would not try to make a political deal with Germany's EC partners to achieve EMU without meeting the convergence criteria outlined in the Maastricht Treaty. See the BDI's Reinhard Kudiss's "ECU 2000-Riskanter Automatismus," *Arbeitgeber* 2, no. 44 (1992); for the DIHT's position see *Frankfurter Allgemeine Zeitung,* 8 April 1992.

72 *The European,* 2–8 May 1996.

73 The important role of the interest organizations in shaping public opinion through the media following the Maastricht summit was touched on in several interviews with government officials and interest group functionaries.

74 *Die Welt,* 2 June 1996.

75 To help change public attitudes toward EMU, the German government hired the von Mannstein advertising agency in March 1996. *Handelsblatt,* 14 February 1996.

76 The European Community became the European Union in 1993. In 1995, the EU decided to name the common currency for EMU the "euro."

77 See *Frankfurter Allgemeine Zeitung,* 22 September 1992; *Handelsblatt,* 24 September 1992.

78 *Handelsblatt,* 28 September 1992.

79 *Financial Times,* 5 November 1994.

80 *Handelsblatt,* 28 November 1995; *Die Welt,* 11 December 1995; *Handelsblatt,* 15 April 1996.

81 The German government was also engaged in talks with the French government on the formation of a "Stability Council" in the winter of 1997. German Finance Minister Theo Waigel proposed an informal council to coordinate economic policy after the start of EMU. The French government picked up the idea and suggested that the council could give advice on monetary policy to the European Central Bank (ECB). The German government rejected this idea as an infringement on the independence of the European Central Bank. The French government gave up the idea of the council giving advice to the ECB due to German pressure in March 1997. See *Financial Times,* 13 March 1997.

82 Deutsche Pressagentur, 27 January 1996.

83 *Financial Times,* 14 December 1996. The French government wanted the word *growth* added to the pact so that the French public would not think of the pact as a threat to job creation.

84 In September 1996 the fine was worked out to be .2 percent of GDP for going over the 3 per-

cent budget deficit limit and .1 percent for every 1 percent over the 3 percent. The ceiling for the debt was .5 percent. The debt would be waived for countries facing a 2 percent drop in GDP over a period of four quarters. *Financial Times,* 30 August 1996 and 13 September 1996.

85 In April of 1997 EU leaders agreed to officially pick the entrants for EMU in the early part of May 1998. See *Financial Times,* 7 April 1997.

86 For Tietmeyer's statements see *Die Welt,* 14 February 1996; *Handelsblatt,* 21 March 1996; *Frankfurter Allgemeine Zeitung,* 21 March 1996. For Jochimsen's statements see *Kölner Stadt-Anzeiger,* 8 March 1996, and *Handelsblatt,* 26 March 1996.

87 For the DIHT position on delaying EMU see *Handelsblatt,* 24 April 1996, and DIHT, "Zur Europäischen Wirtschafts- und Währungsunion (EWWU)," February 1996; for the savings banks' position see *Frankfurter Allgemeine Zeitung,* 3 March 1996 and 16 April 1996.

88 A survey done by the DIHT of firms in 1995 showed that only one-third of small firms (with less than twenty employees) supported the start of EMU in 1999. Firms employing over one thousand employees were 64 percent in favor of starting in 1999. See "Corporate Views on a European Currency" DIHT, Economics Department memo, September 1995.

89 *Handelsblatt,* 21 May 1996. Other major German politicians to suggest delaying the start of EMU were Kurt Biedenkopf, CDU Minister-President of Saxony, and Edmund Stoiber, CSU Minister-President of Bavaria.

90 Core countries were those who would qualify for entry into EMU based on the Maastricht treaty criteria.

91 *Handelsblatt,* 7 March 1996; *Süddeutsche Zeitung,* 26 February 1996; *Die Welt,* 24 March 1996.

92 *Handelsblatt,* 26 February 1996; *Süddeutsche Zeitung,* 20 March 1996.

93 BDB, "Der Euro-stabiles Geld für Europa," *BDB Daten, Fakten, Argumente,* April 1996. See also *Handelsblatt,* 5 February 1996; *Süddeutsche Zeitung,* 30 April 1996; *Süddeutsche Zeitung,* 7 May 1996.

94 *Frankfurter Allgemeine Zeitung,* 18 April 1996.

95 *Handelsblatt,* 28 November 1995; *Frankfurter Allgemeine Zeitung,* 14 February 1996; *Handelsblatt,* 14 February 1996; *Die Welt,* 14 February 1996.

96 Finance Minister Waigel claimed in 1997 that the German budget deficit would be 2.9 percent of GDP in 1998. This number was treated with a great amount of skepticism by almost all organizations outside of the government. *Financial Times,* 19 March 1997.

97 *Financial Times,* 24 March 1997.

98 Interview with senior Bundesbank official. Finance Minister Theo Waigel faced a very difficult time trying to assure the German public of the German government's commitment to the EMU convergence criteria and at the same time convince other EU states that Germany would join EMU in 1999. Waigel often was caught by the press giving contradictory remarks. In March of 1997 Waigel was quoted as saying that "three means three" in reference to his commitment to meet the 3 percent budget deficit limit set out in convergence criteria for EMU. In the same month he stated that Germany was not "nailed to the cross" of the convergence criteria, implying that Germany would join EMU even if it did not meet the 3 percent budget deficit limit in 1998. His backtracking on this remark raised the uncertainty in Germany and abroad as to what the German government intended to do about the convergence criteria.

6 The Price of Change: German Policy and the Transformation of the EMS

1 Interview with German banker.

2 Except for the deutsche mark–guilder parity, which was to be kept at 2.25 percent. See "Com-

muniqué of the European Community, Brussels, 2 August 1993," in Deutsche Bundesbank, *Auszüge aus Presseartikeln*, 3 August 1993.

3 *Frankfurter Allgemeine Zeitung*, 3 August 1993.

4 In the run-up to East German elections, the West German government, in an attempt to boost their East German sister party and to lure the East Germans into speedy unification, had promised a 1:1 exchange rate for East Germans when the two economies would unite. The Bundesbank, which had not been informed of the Kohl government's intentions prior to the announcement, reacted by denouncing the plan as a sure way to fuel inflation. But the Bundesbank's objections were overruled, as all the major peak associations sided with the Kohl government because of their own expectations of gain from rapid unification. See Marsh (1992) and Henning (1994) for a discussion of the exchange rate battle.

5 Children up to fifteen years old were allowed to exchange up to 2,000 East-marks; adults up to the age of fifty-nine could exchange their first 4,000 East-marks at a 1:1 rate; and adults over sixty could exchange their first 6,000 marks at the 1:1 rate. The rest of private holdings as well as financial claims and debts were to be exchanged at a 2:1 rate.

6 Two options for privatizing east German firms and property existed: compensation or restitution. Compensation meant that former owners of east German properties would be compensated for their loss rather than have the Treuhand (the holding agency charged with privatizing east German property) search for and restore the property to its former owners. Restitution was chosen over compensation as the guiding principle for the east German privatization campaign because of the political pressure exerted by former property owners, the Free Democrats, and because powerful German state organizations, such as the Ministry of Justice, argued that not only was restitution the legal avenue according to the German Basic Law, compensation would be too expensive. See Sinn and Sinn (1992, chap. 4) and Schnabel (1992).

7 *Financial Times*, 18 February 1992; *Financial Times*, 10 April 1992.

8 The less important Lombard rate was raised from 8 percent in 1989 to a peak of 9.75 percent in December of 1991.

9 *Geschäftsbericht der Deutschen Bundesbank*, 1991, pp. 42–43; *Financial Times*, 19 August 1992.

10 *Financial Times*, 19 August 1992.

11 *Financial Times*, 17 July 1992.

12 Ibid.

13 *Financial Times*, 7/17/1992.

14 Interview with senior BVR functionary.

15 French political and economic actors were particularly vocal in their criticism of Bundesbank policy. France, which had the highest real interest rates in the EMS despite an inflation rate of 3 percent, was unable to lower its rates because of the floor established by the high German discount rate. Investment in French industry fell by 7 percent in 1991 and was set to fall by 8 percent in 1992.

16 *Financial Times*, 17 July 1992.

17 Interview with senior Bundesbank official.

18 Some of Germany's EMS partners used the September 7 meeting of the EC finance ministers in Bath, England, to try to pressure Schlesinger to lower interest rates. In the face of the pressure, Schlesinger argued that there was no room to lower rates in the face of a growing money supply and inflation. See *Handelsblatt*, 7 September 1992; *Frankfurter Allgemeine Zeitung*, 7 September 1992.

19 Kohl himself was under pressure from French President François Mitterrand to prevent a

crisis in the EMS that would doom the chances of the Maastricht referendum to pass. See *Financial Times*, 15 September 1992.

20 It has been reported that the Bundesbank also suggested that the pound be devalued, but for reasons that remain unclear, nothing came of the suggestion.

21 *Financial Times*, 15 September 1992; *Frankfurter Allgemeine Zeitung*, 15 September 1992.

22 *Frankfurter Allgemeine Zeitung*, 15 September 1992. Schlesinger had this to say: "The amount was extraordinarily high, higher than ever before in a speculative crisis. We were in a situation in which we, with the strongest EMS currency and thus having to absorb all the funds, were really no longer in a position to continue our monetary policy." Quoted in *Financial Times*, 15 September 1992.

23 *Frankfurter Allgemeine Zeitung*, 16 September 1992. The interview and the subsequent exit of the pound from the ERM was to spark a war of words between the German and British authorities. See *Financial Times*, 2 October 1992; *Die Welt*, 2 October 1992; *Financial Times*, 2 October 1992.

24 As the pound and lira were pulled from the ERM, the Spanish peseta was devalued by 7 percent.

25 *Süddeutsche Zeitung*, 18 September 1992.

26 Deutsche Bundesbank, *Monthly Report*, January 1993, p. 32.

27 M3 is a measure of money stock that includes currency and sight deposits of domestic nonbanks with domestic banks, time deposits of domestic nonbanks for less than four years, plus savings deposits of domestic nonbanks at statutory notice.

28 *Wall Street Journal*, 21 October 1992. See also "Germany's Central Bank Pledges to Stay on Course: Interview with Dr. Hans Tietmeyer," Deutsche Bundesbank, *Auszüge aus Presseartikeln*, 29 January 1993. The Bundesbank gave itself more room for its monetary policy in 1993 by announcing that its M3 growth target would be 4.5 percent to 6.5 percent. This widening of the growth target was greeted by the government, industry, and commercial banks as a sign that the Bundesbank was showing willingness to relax its monetary policy to stimulate economic growth. *Handelsblatt*, 14 December 1992.

29 "EG-Gipfel muss ein beschäftigungspolitisches Signal setzen," *DGB Nachrichtendienst*, 30 November 1992.

30 "Bundesbank: Eigene Unfehlbarkeit beweihräuchern," *DGB Nachrichtendienst*, 18 December 1992.

31 *Financial Times*, 14 January 1993.

32 Interviews with BDI, DIHT, and BDB functionaries.

33 *Wall Street Journal*, 5 February 1993. At a press conference to announce the February discount rate reduction, Helmut Schlesinger said, "We hope the speculation is now over," and referred to the months following the September crisis as "an unfriendly domino game in which speculators knock down one currency after the next."

34 *Financial Times*, 16 March 1993.

35 *Frankfurter Allgemeine Zeitung*, 19 March 1993; *Frankfurter Allgemeine Zeitung*, 23 April 1993; "Bundesbank: wachsender Realitätsverlust," *DGB Nachrichtendienst*, 4 March 1993; *Süddeutsche Zeitung*, 18 March 1993; *Handelsblatt*, 1 April 1993.

36 Interview with senior BDI functionary.

37 Interview with senior Bundesbank official.

38 In the wake of the September crisis, the German and French governments and central banks issued a statement affirming their position that the central rates of the franc and the deutsche

mark accurately reflected their countries' economic situations and no change in the rates was warranted. *Deutsche Bundesbank Annual Report*, 1992, p. 49.

39 *Financial Times*, 3 December 1992.

40 *Frankfurter Allgemeine Zeitung*, 25 January 1993; *Welt am Sonntag*, 28 February 1993.

41 See Samuel Brittan, "Germany Fails the Maastricht Test," *Financial Times*, 4 February 1993. In the article, Samuel Brittan discusses suggestions for repairing the EMS made at the 1993 Davos World Economic Forum.

42 At a meeting of EC finance ministers and central bank governors in Kolding, Denmark, on 25 May, the decision was to merely realign currencies in a more timely fashion, although the French government maintained its no devaluation commitment. *Börsen-Zeitung*, 25 May 1993; *Frankfurter Allgemeine Zeitung*, 24 May 1993.

43 *Financial Times*, 24 November 1992; *Frankfurter Allgemeine Zeitung*, 27 November 1992.

44 The Spanish peseta and the Portuguese escudo were devalued by 6 percent on November 23, 1992. The Irish pound was devalued by 10 percent on 1 February 1993. The franc parity was left unchanged for the political reasons given earlier. On 5 January 1993, the French and German governments once again announced their intentions of maintaining the deutsche mark–franc parity.

45 *Financial Times*, 22 June 1993.

46 *Financial Times*, 13 July 1993.

47 Interview with Ministry of Finance officials; interviews with BDI, DIHT, BDB, and DSGV functionaries.

48 The Bundesbank had instituted a bilateral credit arrangement with the Banque de France called a "swap credit" to help finance interventions in times of currency crisis.

49 *Financial Times*, 29 July 1993.

50 *Financial Times*, 30 July 1993.

51 Interview with senior Bundesbank official.

52 The French actually called for the fluctuation margin of 15 percent, as they felt that 6–8 percent was not enough and would "give speculators slices of meat on the table." David Marsh, "Faultlines Show in Franco-German Unity," *Financial Times*, 13 December 1993.

53 Interview with senior Bundesbank official.

54 *Frankfurter Allgemeine Zeitung*, 3 August 1993; "Erste Reaktion des DBV auf Währungsbeschlüsse," *DBV-Pressedienst*, 2 August 1993.

55 There was fear after it was agreed in 1993 that there would be a multispeed EMU, that those countries which did not join EMU in 1999 would see runs on their currencies. Those countries, which expected to get in, namely France and Germany, also feared that the "outs" could use currency dumping to make their exports more competitive. Thus the idea of an EMS II was discussed in 1996 to set stable exchange rates between EMU participants and those EU states outside of the monetary union. The idea revived the old symmetric versus asymmetric debate as occurred with the creation of the EMS in 1978–79. The German Bundesbank and Finance Ministry represented the German position, calling for the new EMS to be asymmetric, as was the old EMS. *Financial Times*, 11 April 1996; *Frankfurter Allgemeine Zeitung*, 15 April 1996; *Die Welt*, 15 April 1996.

7 Conclusion

1 Interview with DGB functionary.

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Index

Aachen summit, 1, 54–55
Adenauer, Konrad, 22, 23
agriculture organizations. *See* German Farmers' Union
Alphandèry, Edmond, 103
American Federal Reserve, 25
anchor currency, 1, 56, 58, 61, 103
Apel, Hans, 46, 116 n.4
Association for the Protection of the German Saver (Sparschützer Gemeinschaft or GSDS), 34–35, 65, 76, 101. *See also* banking organizations
asymmetric monetary regime, 45, 47, 54, 58–59, 102

Balladur, Edouard, 65, 103, 105
Banca d'Italia, 59
Bangemann, Martin, 64, 65, 73
Bank deutscher Länder (BdL), 25
bank-industry relations, 32–33
banking organizations, 9, 24, 50–51, 61, 65, 72, 75, 78–79, 81–83, 94, 102–103, 107, 110–112, 114, 121 n.12, 125 n.71. *See also* Association for the Protection of the German Saver; Federation of German Banks; Federation of German Cooperative Banks; German Savings Bank Federation
Bank of International Settlements, 61
banks. *See* cooperative banks; savings banks; universal banks
Banque de France, 50, 59, 63, 129 n.48
Barre Report, 43
Basel-Nyborg Agreement, 56, 61–62, 102
Basic Law, 24, 117 n.9, 127 n.6
Bavaria, 37–38. *See also* Christian Social Union (CSU)
BDA. *See* Federation of German Employers
BDB. *See* Federation of German Banks
BDI. *See* Federation of German Industry
BdL. *See* Bank deutscher Länder
Belgian Compromise, 120 n.31
Belgium, 56, 71, 105, 120 n.9
Bérégovoy, Pierre, 66
Biedenkopf, Kurt, 126 n.89
Bosch, 74
Brandt, Willy, 43, 46
Bremen Communiqué, 51–52, 53
Bremen European Council, 51
Bremen summit, 51, 53
Bretton Woods monetary regime, 10, 28, 44
Britain. *See* United Kingdom
British pound: in the ERM, 96, 97, 98, 128 n.20, n.24
budget deficit(s), 80, 85–86, 97–98, 125–126 n.84, 126 n.96 and n.98
Bundesbank: and banking and industry organizations, 28; Central Bank Council, 25, 51, 64, 65, 104, 117 n.6; credibility, 27, 97; Directorate, 25–26, 34, 36, 101; legal autonomy, 24–25; monetary policy instruments, 26; president's powers, 26; restructuring of 1992, 117 n.3, n.6, and n.7; view on exchange rate stability, 28. *See also* Emminger; Pöhl; Schlesinger; Tietmeyer
Bundesbank Law of 1957, 24–25, 63, 65
Bundesrat, 21
Bundestag, 21, 30, 67
BVR. *See* Federation of German Cooperative Banks

Carter, Jimmy, 46
CBC. *See* Bundesbank
CDU. *See* Christian Democratic Union
central bank. *See* American Federal Reserve; Banca d'Italia; Banque de France; Bundesbank

Central Bank Council (CBC). *See* Bundesbank
central parities in the Exchange Rate Mechanism. *See* exchange rate parities
"chancellor democracy," 22
Chancellory, 20–23, 40, 112–113; at Aachen summit, 1, 54–55; acceptance of EMS asymmetry, 52–53; and Bremen summit, 51–52; conflict with Finance Ministry over EMS idea, 46; and decision to transform the EMS, 104–106; description of duties, 21–23; discussion with the Bundesbank concerning the design of EMS, 51–55; and EMU initiative, 69, 72–77; and Franco-German Economic and Finance Council initiative, 57–64; and Franco-German Economic and Finance Council Treaty ratification, 64–68; and German unification, 77–79; and German unification-for-EMU deal, 77–79; and Giscard's plans for the EMS, 42, 46–48, 50–55; and Maastricht negotiations, 82–84; meeting with interest organizations prior to Bremen summit, 51; plans for a symmetric EMS, 47–48, 52–55; popularity, 72, 84–85; post-Maastricht public relations, 84–88; and Roy Jenkins's EMS initiative, 42, 46. *See also* Kohl; Schmidt
Chevènement, Jean-Pierre, 60, 71
Chirac, Jacques, 65, 72
Christian Democratic Union (CDU), 31, 37, 49, 67, 120 n.23
Christian Social Union (CSU), 37–38, 49, 120 n.23
Clappier, Bernard, 50
Commerzbank, 50, 75, 97
Committee of Central Bank Govenors, 50, 53, 61, 124 n.50
Common Agricultural Policy (CAP), 3, 43, 44, 46, 47, 74, 106
continuous policy: definition, 13
convergence criteria, 80, 83–84
cooperative banks, 33–34, 76
Copenhagen summit, 48
corporatism: definition, 14; in German monetary policy, 20
CSU. *See* Christian Social Union
currency dumping. *See* exchange rate dumping
currency reserves, 4, 34, 47, 61
currency union. *See* German monetary union

Daimler Benz, 74, 96
DBV. *See* German Farmers' Union
Delors Committee, 76–77, 123 n.29; report of, 77
Denmark, 77, 105, 121 n.9
Deutsche Bank, 50, 75
Deutsche Bundesbank. *See* Bundesbank
deutsche mark (DM), 3, 40, 58–61, 71, 73, 75, 84–85, 88, 97, 100, 102–106, 129 n.38 and n.44
deutsche mark zone, 4, 45, 58, 120 n.3
devaluation(s), 59–60, 103, 128 n.20
DGB. *See* German Union Federation
DIHT. *See* German Chambers of Commerce
discontinuous policy: definition, 13
discount rate, 96, 101, 104, 128 n.33
DM. *See* deutsche mark
dollar, 119 n.5
domestic monetary policy: in the wake of unification, 93–94, 97–102
domestic price stability, 90, 93, 101, 106, 111
dominance: of the EMS by the Bundesbank, 4–5, 57–64, 69, 71–74
Dresdner Bank, 50, 75, 93
Dublin summit, 86, 124 n.54
Dutch guilder, 126 n.2

Eastern Europe: as a factor in German policy, 77
East German mark. *See* German monetary union
EC. *See* European Community
ECB. *See* European Central Bank
Economics Ministry, 20, 31, 38, 40, 63–65; attitude toward EMU initiative, 73; role in Franco-German Economic and Finance Council initiative, 64–65. *See also* Bangemann
"economist" approach to EMU, 44, 71, 82, 83, 123 n.31
ecu. *See* European Currency Unit
Eichengreen, Barry, 2
EMF. *See* European Monetary Fund
Emminger, Otmar, 51, 52, 120 n.2
EMS. *See* European Monetary System
EMU. *See* European Monetary Union

Erhard, Ludwig, 23
ERM. *See* Exchange Rate Mechanism
escudo. *See* Portugese escudo
EU. *See* European Union
EUA. *See* European Unit of Account
euro, 40, 188 n.35
European Central Bank (ECB), 69, 73, 74, 75, 79, 81, 83, 123 n.31, 124–125 n.67, 125 n.81
European Community (EC), 3–6, 8, 43–48, 56, 61, 67–68, 69–71, 73–78, 90, 94–96, 103
European Currency Unit (ecu), 52–54, 57–58
European Monetary Cooperation Fund, 61
European Monetary Fund, 48, 49, 52, 54, 58
European Monetary System (EMS), 1–6, 10, 17–18, 69, 71–72, 109–113, 115; Bundesbank resistance to initiation, 47–51; Bundesbank role in design, 51–55; design negotiations, 53–55; and economic growth, 120 n.5; exchange rate crises, 96–106; "minimalist" vs. "maximilist" debate, 53–55; reform attempts, 59–62; symmetry debate, 42–55; transformation of, 90–116
European Monetary Union (EMU), 2, 5, 8, 17, 36, 40, 90, 94, 100, 102, 104, 106–107, 111, 113–116; Bundesbank brinkmanship, 79–84; Bundesbank reaction to French initiative, 73; "economist" vs. "monetarist" debate, 44, 71; failure of first initiative, 45, 71; first initiative, 43–45, 70–71; German unification-for-EMU deal, 77–79; IGC negotiations, 79–82; Maastricht negotiations, 82–84; Maastricht Treaty ratification, 84; positions of interest organizations on EMU initiative, 72–76; second initiative, 71–77; "two-speed" EMU debate, 85–88
European Parliament, 78
European Union (EU), 3–5, 8, 37, 69, 88, 115
European Unit of Account (EUA), 47, 48, 119 n.9
exchange rate dumping, 31
Exchange Rate Mechanism (ERM): explanation of operation, 53–55; Britain's exit from the ERM, 97; Italy's exit from the ERM, 97. *See also* European Monetary System
exchange rate parities (in the Exchange Rate Mechanism), 100, 102–103, 106
exchange rate policy, 20, 24, 91–93
exchange rate stability, 3, 28, 31, 36, 44, 56, 58–59, 65, 75, 106

FDP. *See* Free Democrat Party
Federal Constitutional Court, 64
Federal President, 25
Federation of German Banks (BDB), 33, 50, 51, 65, 67, 76, 79, 81, 87, 100, 101, 119 n.18
Federation of German Cooperative Banks (BVR), 34, 65, 76, 79, 93
Federation of German Employers (BDA), 118 n.10
Federation of German Industry (BDI), 31–32, 35, 49, 50, 51, 64, 65, 67, 75, 79, 81, 82, 86, 87–88, 93, 100, 101, 118 n.13
Finance Ministry, 3, 20–21, 23, 28, 31, 33, 35, 40, 112–114; attitude toward EMS initiative, 46; attitude toward EMS symmetry issue, 54; attitude toward first EMU initiative, 43; attitude toward transforming the EMS and German unification, 97–105; description of duties, 24; role in EMU-IGC negotiations, 81–82; role in Maastricht Treaty negotiations, 83; post-Maastricht attitude toward EMU, 86–88. *See also* Apel; Stoltenberg; Waigel
Foreign Office, 112–113; attitude toward Franco-German Economic and Finance Council initiative, 66–68; description of duties, 28–29; post-Maastricht attitude toward EMU, 87–88; role in EMU-IGC negotiations, 82–83; role in Maastricht Treaty negotiations, 82–83. *See also* Genscher
France (French government): dissatisfaction with EMS, 56–59, 69–72; and EMS initiative, 46–48; and EMS symmetry debate, 53–55; and the EMU-IGC, 82–83; and EMU initiative, 71–72; and Franco-German Economic and Finance Council initiative, 62–64; and German unification-for-EMU deal, 77–79; and Maastricht Treaty negotiations, 82–83; monetary policy decisions, 103; negotiations on the transformation of the EMS, 103–106; and Stability and Growth Pact, 86, 125 n.83; and Stability Council, 125 n.81.
Franco-German Economic and Finance Council, 2, 5, 8, 17, 36, 40, 111, 113, 115; Bundesbank

F.-G. E. and F. C. (*continued*)
reaction to draft treaty, 64–66; initiation, 62–63; position of interest organizations, 64–67; treaty changes, 66–68; treaty ratification, 67–68
Franco-German Friendship Treaty of 1963, 5, 62
Free Democrat Party (FDP), 23, 29, 31, 38, 56, 64, 67, 72, 73–74, 78, 118 n.33, 122 n.9, 127 n.6
French central bank. *See* Banque de France
French elections, 67
French EMU referendum of 1992, 96
French franc: in the ERM, 49, 54, 58, 59–60, 96, 98, 100, 103, 106, 128–129 n.38, 129 n.44
Frieden, Jeffry, 2
functionalism, 6, 108. *See also* neo-functionalism

Gaulle, Charles de, 119 n.2
GDR. *See* German Democratic Republic
Geiger, Helmut, 97
Genscher, Hans-Dietrich, 8, 29, 67, 72–73, 77, 81, 82, 83
Genscher memorandum, 73–74, 122 n.9
German Central Bank. *See* Bundesbank
German Chambers of Commerce (DIHT), 32, 35, 49, 51, 65, 75, 81, 82, 86, 87, 88, 97, 100, 101
German Democratic Republic (GDR), 80, 118 n.29
German elections, 78, 85
German Farmers Union (DBV), 36–37, 75, 78, 81, 105, 118 n.29 and n.33
German monetary union, 91–94, 123–124 n.47, 127 n.4 and n.5
German Savings Bank Federation (DSGV), 33, 50, 65, 76, 79, 81, 86, 97, 101
German unification, 91–94, 123 n.40
German Union Federation (DGB), 35–36, 48, 67, 78, 81, 82, 87, 100; and Bundesbank, 35; and Finance Ministry, 35; and SPD, 35
Giscard d'Estaing, Valéry, 42, 46, 47, 48, 50, 54–55
Grauwe, Paul De, 120 n.5
Greece, 77, 95
Greens, 38–39, 87
GSDS. *See* Association for the Protection of the German Saver
G-7 meetings, 23, 24
guilder. *See* Dutch guilder

Haggard, Stephen, 7
Hague summit, 43, 44
Hannover summit, 76
Herrenhausen, Alfred, 75
Hueglin, Thomas, 8
hyperinflation, 25

IGC. *See* Intergovernmental Conference
IG Metall, 118 n.25
independent policy-making authority: definition, 19
industry organizations, 24, 28, 42, 48, 50, 61, 70, 72, 76, 78–79, 81, 83–85. *See also* Federation of German Industry
inflation, 11, 22–25, 34, 43–44, 46, 48–50, 52, 58–60, 80, 84–85, 97, 99–101, 127 n.15 and n.18; as a consequence of German unification, 91–94
interest rates: and the ERM, 94, 96–97, 99–105. *See also* Bundesbank; monetary policy instruments
Intergovernmental Conference (IGC): for EMU, 70, 77, 79, 80, 123 n.54
investment, 87, 92
Ireland, 95, 119 n.3
Italian central bank. *See* Banca d'Italia
Italian lira: in the ERM, 49, 59, 94, 96, 97, 98, 100, 128 n.24
Italy, 4, 5, 56, 71, 77, 82, 83, 94, 120 n.9
institutionalist model, 12–17
institutions: definition, 9; distributional theory, 10–11; formal, 9–10; informal, 9–10; transaction cost theory, 10
international regimes: definition, 6
intramarginal interventions, 58–59, 60, 62, 106

Jenkins, Roy, 42, 46
Jochimsen, Reimut, 86
Justice Ministry, 67, 127 n.6

Katzenstein, Peter, 113, 119 n.7
Keohane, Robert, 6–7
Kinkel, Klaus, 29, 88
Knight, Jack, 10–11
Kohl, Helmut, 8, 40, 113; and decision to

transform the EMS; and EMU initiative, 69, 72–77; and Franco-German Economic and Finance Council initiative, 57–64; and Franco-German Economic and Finance Council Treaty ratification, 64–68; and German unification, 77–79; and German unification-for-EMU deal, 77–79; and Maastricht negotiations, 82–84; popularity, 72, 84–85; post-Maastricht public relations, 84–88
Krupps, 32

Lambsdorff, Otto, 23
Land Central Banks (LCBs), 26
Larosière, Jacques de, 65, 103, 105
LCBs. *See* Land Central Banks
liberalization of capital controls, 94–96, 123 n.31
Lombard Rate, 96, 104, 127 n.8
Luxembourg, 86

Maastricht summit, 77, 82, 89, 124 n.58
Maastricht Treaty, 2, 40, 69, 83, 84, 85, 88, 90, 93, 96, 102, 106, 111, 125 n.71; Bundesbank reaction, 83–84; German public reaction, 84–85; interest organizations reaction, 84
marginal interventions, 58–59, 60, 62, 106
Marxist approach, 8–9, 16–17, 113–114
Medium-Term Financial Assistance, 54
minimum winning coalition, 12
Ministry for Nourishment and Agriculture, 37
Mitterrand, François, 77, 78, 127 n.19
Möllemann, Jürgen, 24
"monetarist" approach to EMU, 44, 71, 82, 83
monetary targeting, 27, 99
M3, 99, 100, 128 n.27 and n.28
multispeed EMU, 85, 129 n.55

neo-functionalism, 10–11, 109
Netherlands, 71, 77, 105, 106, 121 n.9
new institutionalism, 12
North, Douglass, 10–11, 117 n.1
Norway, 119 n.3, n.4

Office of Money and Credit, 23
oil shock (crisis), 45
open market operations,
organization: definition, 10
Ostpolitik, 43

parity grid (ERM), 53–54
peak associations, 29–37, 101
peseta. *See* Spanish peseta
Pöhl, Karl-Otto, 55, 61, 73
policy coalitions: explanation of formation, 11–12
policy dynamics: definition, 13
Portugal, 95
Portugese escudo, 129 n.44
pound. *See* British pound
privatization (GDR), 92, 127 n.6
public opinion, 39–40, 83, 84–85, 86, 122 n.11

realignment(s): in the ERM, 59–60, 129 n.42
Rome summit, 81–82
Rohwedder, Detlev, 91
Rueff, Jacques, 119 n.2

Sandholtz, Wayne, 8
savings banks, 32–34, 50, 76, 79, 81, 83, 86
Schlesinger, Helmut, 97, 102, 105, 118 n.10, 127 n.18, 128 n.22 and n.33
Schmidt, Helmut, 3–4, 22; at Aachen summit, 1, 54–55; acceptance of EMS asymmetry, 52–53; and Bremen summit, 51–52; conflict with Finance Ministry over EMS idea, 46; discussion with the Bundesbank concerning the EMS design, 51–55; and Giscard's plans for the EMS, 42, 46–48, 50–55; meeting with interest organizations prior to Bremen summit, 51; plans for a symmetric EMS, 47–48, 52–55; and Roy Jenkins's EMS initiative, 42, 46
Schröder, Gerhard, 87
Schulmann, Horst, 50
Short-Term Monetary Support, 54
Simmons, Beth, 7
single market, 73
"small" union debate, 85
Smeets, Heinz-Dieter, 120 n.3
Smithsonian Agreement, 44–45
"Snake in the tunnel," 45, 47, 54, 119 n.3, n.4, and n.9

Social Democrat Party (SPD), 37, 40, 48, 56, 64, 73–74, 78, 82, 87, 113 n.33
Solidarity Pact, 101
Spain, 77, 95
Spanish peseta, 128 n.24, 129 n.44
SPD. *See* Social Democrat Party
Stability and Growth Pact, 86, 125 n.83
Stability Council, 125 n.81
Stability Pact. *See* Stability and Growth Pact
state-centric approach, 7–8, 114
Stoiber, Edmund, 126 n.89
Stoltenberg, Gerhard, 62, 65, 73
Strasbourg summit, 78, 79
Strauss, Franz-Josef, 120 n.23
swap credit, 105, 129 n.48
Sweden, 119 n.3, n.4
symmetric vs. asymmetric debate, 129 n.55
systems of access to policy making: constraining, 14; corporatist, 14; "no access," 14–15

Tietmeyer, Hans, 19, 85, 86, 100
transfer payments, 92
Treaty of Rome, 43, 79, 119 n.1, 123 n.31
Treuhand, 91, 127 n.6

unemployment, 58, 91–92, 100
unions. *See* German Union Federation (DGB); IG Metall
United Kingdom, 4, 48, 94, 119 n.3
unity surcharge, 92
universal banks, 32–33, 75, 101

Very Short-Term Financing Facility, 54, 60, 61

wage equalization, 91–92
Waigel, Theo, 77, 82, 83, 86, 88, 96, 97, 105, 126 n.96, 98
Werner, Pierre, 70
Werner Committee. *See* Werner Report
Werner Report/Plan, 44, 70, 71

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